



Consumer Federation of America

June 4, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-05-20
Facilitating Capital Formation and Expanding Investment Opportunities by Improving
Access to Capital in Private Markets

Dear Ms. Countryman,

We are writing on behalf of the Consumer Federation of America (CFA)¹ to voice our strong opposition to the Commission's latest sweeping proposed amendments to offerings that are exempt from registration.² Like the earlier Concept Release on the exempt offering framework (Concept Release),³ these proposals reflect an ideologically driven approach to rulemaking in which meaningful economic analysis plays no role and investors' concerns are treated as irrelevant. The Commission characterizes its proposed amendments as technical changes designed to "simplify, harmonize, and improve certain aspects of the exempt offering framework to promote capital formation while preserving or enhancing important investor protections."⁴ In reality, however, the clear intent is to further expand the use of private offering exemptions, without regard to the impact on investor protection or the health of our public markets and without any evidence that doing so would promote healthy, sustainable capital formation.

This is not to suggest that harmonization of the exempt offering framework is an inherently bad idea. As Commissioner Allison Herren Lee said in her public statement on the proposal, "It's reasonable to examine the increasingly complex patchwork of exemptions from

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 Proposed Rule, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release Nos. 33-10763; 34-88321; File No. S7-05-20, March 4, 2020, <https://bit.ly/2zKX06M> ("Release").

³ Concept Release on Harmonization of Securities Offering Exemptions, Release Nos. 33-10649; 34-86129; IA5256; IC-33512; File No. S7-08-19, June 18, 2019, <http://bit.ly/2msMUjT> ("Concept Release").

⁴ Release at 1.

registration to ensure the regime is operating well as a whole, eliminate overlap, and fill in gaps.”⁵ Indeed, the insatiable appetite in Congress and at the Commission for creating new exemptions, each with its distinct conditions and requirements, creates the need for the harmonization that this release purports to provide.⁶ The problem, as Commissioner Herren Lee explained, is that the current proposal “goes far beyond what can rightly be called harmonization. If adopted, it would erode significant distinctions between the public and private markets that are well-grounded in law and policy.”⁷

Moreover, the Commission has proceeded with this proposal without bothering to conduct any serious analysis of how the existing framework and proposed changes to that framework would affect investors, market integrity, or capital formation. It is proceeding not based on an assessment of facts, but rather on a mix of anecdote and ideology. Indeed, it has scrupulously avoided collecting the facts needed to support informed policymaking. It is particularly troubling that the Commission continues to deliberately ignore the fundamental question over how the use of private offering exemptions has affected the health and vitality of our public markets and the extent to which the expanded use of private offering exemptions would exacerbate the decline of our public markets. Indeed, if the Commission’s explicit goal were to render our public markets obsolete, its proposed approach would likely include many of these same elements.

Given the fact that investors,⁸ state securities regulators and attorneys general,⁹ leading academics,¹⁰ and others previously raised these concerns in comment letters regarding the Commission’s Concept Release on the exempt offering framework, we are dismayed that the Commission has continued to refuse to conduct even the most basic analysis on an issue that is so central to its mission. We understand that it may be difficult or inconvenient to try to find answers to these questions, particularly given the risk that those answers may not support the Commission’s desired policy goals. But that is the Commission’s job. Difficulty, inconvenience, or the potential that facts on the ground may undermine the Commission’s deregulatory preferences are not proper justifications for the Commission to shirk its responsibilities to engage in fact-based policymaking.

⁵ Commissioner Allison Herren Lee, Statement on Proposed Amendments to the Exempt Offering Framework, March 4, 2020, <https://bit.ly/371dRhO> (“Commissioner Herren Lee Statement”).

⁶ This is not to suggest that we think the requirements of the different exemption need to be harmonized (i.e., brought into closer alignment). Rather, we are suggesting that the exempt offering framework lacks an overarching logic and consistent principles of investor protection that are badly needed. Unfortunately, this proposal goes in the exact opposition direction.

⁷ Commissioner Herren Lee Statement.

⁸ See, e.g., Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>; Letter from Tyler Gellasch, Association, to the SEC, September 30, 2019 <https://bit.ly/3dusegT>; Letter from Dennis M. Kelleher and Lev Bagramian, Better Markets, to the SEC, September 24, 2019, <https://bit.ly/2Mp9CmE>.

⁹ Letter from Christopher Gerold, NASAA, to the SEC, October 11, 2019, <https://bit.ly/2XSaPs2>; Letter from California Attorney General Xavier Becerra, District of Columbia Attorney General Karl A. Racine, Massachusetts Attorney General Maura Healey, and Oregon Attorney General Ellen F. Rosenblum, to the SEC, September 24, 2019, <https://bit.ly/2zXGNer>.

¹⁰ Letter from Erik F. Gerding, et. al., to the SEC, September 24, 2019, <http://bit.ly/2ombQKO>.

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I. The proposal would expand the ability to use private offering exemptions, further expanding private markets, at the expense of public markets and investor protection.

While the release includes a grab-bag of deregulatory proposals, their common theme is that they would allow issuers to use the various offering exemptions to raise more money from more investors with fewer restrictions. The easier it is for issuers to raise unlimited sums of capital in private markets, where they are subject to little regulatory oversight and less accountability to investors, the less incentive or pressure there is on companies to go public. This is already a pressing problem, as the Commission itself has acknowledged elsewhere and as we discussed at length in our comment on the Concept Release. Unfortunately, the current proposals would make that problem worse, including by:

- Gutting the integration doctrine by providing issuers with a roadmap to mix and match their use of different exemptions, and conduct those offerings very close in time, without triggering the Securities Act of 1933's registration requirement. The effect would be to replace the original purpose behind the integration doctrine, preventing evasion of the '33 Act's registration requirement, with a new purpose, providing clear guidance to issuers on how to game the system.
- Allowing issuers greater ability to communicate with the public about potential "private" offerings, thereby enabling issuers to condition the public mind or arouse public interest in offerings of their securities, including in offerings in which general solicitation is, at least in theory, not permitted.
- Revising crowdfunding rules in a way that would render Section 12(g) of the Exchange Act, one of the only remaining mechanisms to push private companies into public markets, even less applicable and less relevant. This would have the effect of reducing market transparency by further expanding the ability of private companies with a large and dispersed shareholder base to avoid becoming public reporting companies.
- Increasing the offering and investment limits for various exemptions, thereby enabling companies to raise more money collectively and individually from investors without complying with the requirements of the '33 Act. Doing so would increase the amount of retail investment that flows to these offerings, which appear to include a significant number of bad deals and scams.

The Commission's proposal is based on underlying assumptions for which it offers no support. The first is that taking these deregulatory steps would promote capital formation. But it fails to provide any evidence to support this assumption and ignores evidence that the opposite is likely to be the case. The second is that these will be great "opportunities" for retail investors. Not only does the Commission fail to offer any real world evidence to support this assumption, it ignores the strong likelihood that retail investors will only be offered the worst deals on the least attractive terms. The least we ought to be able to expect before the Commission moves forward with such a radical proposal is that it would carefully consider these issues. Of course, exploring these issues would require the Commission to collect data and study investors' and issuers' experience in the private markets, something it has steadfastly refused to do.

A. The proposal would gut the integration doctrine, providing firms with a roadmap for evading '33 Act registration requirements.

The Commission claims in the proposing release that its goal is merely to “modernize and simplify” the integration framework and to provide “additional clarity on how securities offerings interrelate.” In reality, however, the proposal would substantially relax the integration doctrine in several important ways, including by weakening the general principle used to determine whether integration is required and by dramatically shortening the cooling off period between offerings. In short, the Commission’s proposal would replace the original purpose behind the integration doctrine, preventing issuers from evading their registration requirements under the '33 Act, with a new purpose, providing them with a roadmap on how to do so. The inevitable result is that issuers will use this new flexibility to make greater use of exemptions, reducing the need or incentive for companies to go public.

In adopting the Securities Act of 1933 amidst the economic wreckage of the Great Depression, Congress sought to ensure that never again would issuers be able to sell their securities to the general public without providing the essential facts necessary to value those securities. To achieve this goal, the Act for the first time imposed a registration requirement for all securities sold through interstate commerce that included both an obligation to provide full and fair disclosure and legal accountability for the accuracy of those disclosures. While the Act included exemptions from these requirements, the exemptions were extremely narrow and limited in scope.¹¹ For example, the purpose of the exemption for “transactions by issuers not involving any public offering,”¹² according to the House Committee Report, was “to permit an issuer to make a specific or an isolated sale of its securities to a particular person.”¹³

For decades after the '33 Act was adopted, the Commission worked to hold the line against those who sought to evade its registration and disclosure requirements. The integration doctrine was a critical element of those efforts. Its purpose was to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that the resulting offerings would qualify for Securities Act exemptions that would not be available for the combined offering.¹⁴ As the Commission reasoned decades ago when explaining the purpose of the integration doctrine, “What may appear to be a separate offering to a properly limited group will not be so considered if it is one of a related series of offerings. A person may not separate parts of a series of related transactions, the sum total of which is really one offering, and claim that a particular part is a nonpublic transaction.”¹⁵

Under this approach, if multiple offerings are integrated, that offering is required to satisfy the conditions of a single, free-standing exemption. In practice, however, an integrated offering is unlikely to fully satisfy the conditions of a single, free-standing exemption. Failure to do so could result in the issuer’s engaging in a Section 5 violation, which carries significant penalties. The risk of engaging in a Section 5 violation encourages issuers to engage instead in a

¹¹ See, e.g., Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

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

¹³ H.R. Rep. No. 73-85 at 15-16 (1933).

¹⁴ See, e.g., Final Rule: Nonpublic Offering Exemption, Release No. 33-4552 (Nov. 6, 1962).

¹⁵ *Id.*

registered (public) offering, with attendant benefits both for market transparency and investor protection.

The Commission for decades used a facts and circumstances test to determine whether multiple offerings should be integrated, based on these five factors, whether: (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose. In recent years, however, as Congress and the Commission expanded the number and complexity of available exemptions, the Commission has begun to shift away from this approach. In 2007, the Commission made it easier for issuers to engage in side-by-side public and private offerings.¹⁶ And, in 2015, the Commission made it easier for issuers to engage in concurrent and serial combinations of Rule 506(b) offerings with offerings under Regulation A, Rule 147, and Regulation Crowdfunding.¹⁷ In short, even before this latest set of proposals, the Commission had already seriously undermined the effectiveness of integration in preventing issuers from evading the '33 Act registration requirement or otherwise engaging in regulatory arbitrage.

At a time when we face mounting evidence that our public markets are in decline precisely because we've eliminated the incentives for companies to go public,¹⁸ the least we ought to be able to expect from the Commission is a careful examination of the role this weakening of the integration doctrine has played in speeding that decline. Instead, without conducting any such analysis, the Commission now proposes to dispense entirely with the integration framework, proposing instead an approach that would ensure that multiple offerings would seldom be integrated, even when they occur in very close proximity in time. The Commission proposes to achieve this, first, by adopting a general principle of integration that “focuses the analysis on whether the issuer can establish that *each offering* either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the *particular offering*.”¹⁹

In other words, the original goal of preventing issuers from artificially separating related transactions into multiple offerings to avoid the registration requirement is gone under this approach, so long as the individual offerings each satisfy a particular exemption. This would subvert the purpose of integration, which specifically looks at the totality of a financing scheme rather than different components in isolation. Instead it would enshrine a framework that effectively allows concurrent and serial offerings that are clearly part of a single plan of financing to avoid integration.

¹⁶ Jason Parsont, The SEC's Evolving Integration Doctrine: New Guidance on Combining Offering Methods, The CLS Blue Sky Blog, January 13, 2016, <https://bit.ly/3dsLWJR> (citing Proposed Rule, Revisions of Limited Offering Exemptions in Regulation D, SEC Release No. 33-8828, at 51-56 (Aug. 03, 2007); C&DI Question 139.25 (Nov. 26, 2008), <https://bit.ly/2zNbtPA>).

¹⁷ *Id.* (citing Final Rule: Crowdfunding, SEC Release No. 33-9974, (Oct. 30, 2015); Proposed Rule: Exemptions to Facilitate Intrastate and Regional Securities Offerings, SEC Release No. 33-9973, (Oct. 30, 2015); and Final Rule: Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A Adopting Release), SEC Release No. 33-9741 (March 25, 2015)).

¹⁸ 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>.

¹⁹ Release at 28 (emphasis added).

In addition to adopting a general integration principle that subverts the original purpose of the doctrine, the Commission has proposed to greatly expand the integration safe harbors. The Commission has historically recognized the need for clarity with regard to whether multiple offerings are integrated and, toward this end, has provided various safe harbors to avoid integration. Where an issuer satisfies the conditions under a particular safe harbor, the offerings will not be considered integrated and there is no need for any further integration analysis. This includes, among others, a safe harbors for several exemptions, including Reg. D and Reg. A, providing that, if an issuer waits six months between multiple offerings, those offerings will not be integrated. Now, the Commission is proposing to shorten that waiting period to just 30 days, an approach that it previously concluded would expose investors to inappropriate risks.

The purpose of the six-month safe harbor is to provide sufficient time between the different offerings to ensure that they are not part of a single plan of financing or a scheme to avoid registration. As the Commission recognized in 2007, when it previously considered shortening the six-month waiting period integration safe harbor in the context of Reg. D offerings, “The current six-month time frame of the safe harbor in Rule 502(a) provides a substantial time period that has worked well to clearly differentiate two similar offerings and provide time for the market to assimilate the effects of the prior offering.”²⁰ The Commission worried, moreover, that “an inappropriately short time frame could allow issuers to undertake serial Rule 506-exempt offerings each month to up to 35 non-accredited investors in reliance on the safe harbor, resulting in unregistered sales to hundreds of non-accredited investors in a year. Such sales could result in large numbers of non-accredited investors failing to receive the protections of Securities Act registration.”²¹ Based on this concern, the Commission specifically rejected a 30-day period in that proposal.²²

Without even acknowledging its past concerns, the Commission cites “changes in technology, the markets, and the securities laws since 1982” to justify the proposed 30-day safe harbor. Specifically, it argues that, “the accelerating speed and consumption of electronically disseminated information in today’s financial marketplace” render a 30-day time frame “sufficient to mitigate concerns that an exempt offering may condition the market for a subsequent registered offering or undermine the protections of a subsequent exempt offering.”²³ It further posits, unsupported by any evidence or analysis, that “the effects of any offers made more than 30 days prior to or after commencement of another offering would be sufficiently diluted by intervening market developments so as to render an integration analysis unnecessary.”²⁴ This is a flimsy justification for such a dramatic change.

First, it is certainly true that the speed at which the financial markets operate and the amount of information available for many aspects of the market has increased dramatically since

²⁰ Proposed rules and Request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828; IC-27922; File No. S7-18-07, August 3, 2007, <https://bit.ly/3csZLXB>.

²¹ *Id.* at 59.

²² *Id.* at 60 (“Some commentators have suggested that a 30-day integration safe harbor would be appropriate. We are concerned that such a short time period could encourage serial private offerings that would otherwise be integrated and effectively allow unregistered public offerings.”); *Id.* at 59 (“We propose, therefore, to lower the safe harbor time frame to 90 days rather than the 30 days recommended by the Advisory Committee.”).

²³ Release at 38-39.

²⁴ *Id.*

the 1980s. However, it does not automatically follow that 30 days between substantially similar offerings somehow cures the risks that led to adoption of the integration doctrine. For example, it does little to address the concern raised by the Commission in 2007, that such a short cooling off period would enable issuers conducting offerings under Reg. D to sell to hundreds of non-accredited investors in a single year by conducting successive Rule 506(b) offerings. Limiting the number of non-accredited investors an issuer could sell to in such offerings to 35 every 90 days, as the Commission proposes, is a step in the right direction, but it is insufficient to address this concern.

Furthermore, the fact that there is a constant flow of information about certain large issuers doesn't mean that information will be readily available for small companies that rely on exempt offerings. So, for example, while the amount of information that is available about Apple or Amazon, and the speed with which that information is disseminated to the public, has certainly increased, that has absolutely nothing to do with the amount of information that is available or the speed with which information is disseminated for a small, private company. That is all the more true when that private company intentionally keeps a tight lid on information about itself and its offerings, refusing to provide any meaningful information to the financial marketplace. When such companies do provide information, the information they provide may not be independently assessed for accuracy, reliability, and quality. In other words, just because there may be a lot of publicly available information about the companies in the S&P 500, that is totally irrelevant to investors' ability to access complete and reliable information about the small, private companies most likely to engage in multiple exempt offerings in close succession, the precise types of transactions at issue here.

Second, while the markets have changed a great deal since the 1980s, today's markets do not look all that different than they did in 2007, when the Commission specifically rejected a 30-day cooling off period for Reg. D offerings on the grounds that it was an insufficient amount of time to indicate that multiple offerings would be truly separate and distinct from one another (not part of a single financing plan), as discussed above.²⁵ Then, the Commission stated, "Some commentators have suggested that a 30-day integration safe harbor would be appropriate. We are concerned that such a short time period could encourage serial private offerings that would otherwise be integrated and effectively allow unregistered public offerings."²⁶ Here again, the Commission doesn't even acknowledge this apparent change in position, much less attempt to explain why a 30-day cooling off period was insufficient in 2007, but is sufficient now.

The 2007 proposal of 90 days appears to have had some rational policy basis. In the 2007 proposal, the Commission reasoned that a 90-day cooling off period was appropriate, "as it would permit an issuer to rely on the safe harbor once every fiscal quarter."²⁷ The Commission continued, "For issuers that provide quarterly reports, the 90-day requirement would provide time and transparency for investors and the market to take into account the offering and its results."²⁸ Moreover, even among those commenters on the Concept Release who supported

²⁵ *Id.*

²⁶ Proposed rules and Request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828; IC-27922; File No. S7-18-07, August 3, 2007, <https://bit.ly/3csZLXB>.

²⁷ *Id.* at 59.

²⁸ *Id.*

shortening the six-month waiting period, most did not advocate for a 30-day time-frame, as the Commission now proposes. A commonly proposed waiting period, cited by several prominent commenters, was 90 days, in line with the Commission's previous proposal.²⁹ Instead, in proposing a 30-day cooling off period, the Commission has adopted the most extreme, least investor-friendly alternative suggested by commenters.³⁰

The proposal includes some modest provisions to prevent issuers from using exemptions together inappropriately. Specifically, the Commission states that the 30-day safe harbor is available provided that, for an exempt offering for which general solicitation is not permitted, the purchasers either: 1) were not solicited through the use of general solicitation; or 2), established a substantive relationship with the issuer prior to the commencement of the offering for which general solicitation is not permitted. We have no confidence that this condition will be complied with or enforced effectively.

As Commissioner Herren Lee pointed out in her statement, this approach is ripe for abuse. Under the current regime, she explained, "an issuer conducting an exempt offering that prohibits general solicitation generally cannot rely on the exemption if investors in the offering were identified or contacted through general solicitation."³¹ Under the new proposal, however, whether the investor was identified through general solicitation no longer matters. "The issuer can still rely on an exemption that purports to prohibit general solicitation as long as the issuer has a reasonable belief of a pre-existing substantive relationship with the purchaser. *Even if that relationship was developed pursuant to general solicitation.*"³² Commissioner Herren Lee goes on to ask whether an issuer could "conduct a general solicitation, ask those who respond to the general solicitation to fill out a few cursory forms, then sell those investors securities in a subsequent offering that bans general solicitation."³³ We agree with Commissioner Herren Lee that, "It is not clear from the proposing release that this scenario would be impermissible."³⁴

Second, the Commission is largely operating in the dark when it comes to overseeing private markets, in part because it has refused to collect even the most basic information about these markets and in part because it lacks the resources to provide day-to-day oversight and

²⁹ See, e.g., Letter from Davis Polk & Wardwell LLP, to the SEC, September 24, 2019, <https://bit.ly/3cuBZKC> ("We agree with the Commission that 90 days is appropriate, as it would provide additional flexibility, permitting issuers to rely on the safe harbor once every fiscal quarter, while still requiring issuers to wait a sufficient period of time before initiating a substantially similar offering in reliance on the safe harbor rule."); Letter from the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association, to the SEC, October 16, 2019, <https://bit.ly/2U41ZGj> ("The Commission should consider shortening this period, for example, to 90 days as it previously proposed, on the basis that such period ensures sufficient separateness.").

³⁰ See Letter from U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, to the SEC, September 24, 2019, <https://bit.ly/2Mp3JWo> ("In addition, the CCMC supports shortening the integration safe harbor in Rule 502(a) of Regulation D from six months to 30 days. In the electronic information age in which we now live, the six-month period is an eternity."); Letter from Securities Industry and Financial Markets Association, to the SEC, September 24, 2019, <https://bit.ly/302ZFDA> ("[T]he existing six-month cooling off period should be reduced to 30 days.... We believe a 30-day cooling off period is appropriate in today's marketplace given issuers' need to be able to raise capital quickly (and frequently) combined with investor expectation that offerings can and will be able to move quickly and efficiently.").

³¹ Commissioner Herren Lee Statement.

³² *Id.* (emphasis added)

³³ *Id.*

³⁴ *Id.*

tough enforcement.³⁵ As a result, there would be little deterrence and thus little incentive for compliance. An issuer that waits the requisite 30 days could, either intentionally or inadvertently, use general solicitation and public advertising to sell securities to non-accredited investors, where the issuer would otherwise be prohibited from doing so, with little risk that such activity would be discovered or enforced against by the Commission. This would permit precisely the sort of evasion of the Securities Act's registration requirements that the integration doctrine was intended to prevent.

The Commission acknowledges that these concerns are valid. It states, for example, that “a decrease in the integration of multiple offerings might result in inadvertent overlaps in solicitation of investors for offerings with different communications provisions. For example, Rule 506(b) and Section 4(a)(2) offerings that do not allow general solicitation may be preceded by offerings relying on exemptions that allow general solicitation (such as Regulation Crowdfunding, Regulation A, or Rule 506(c)), which could condition the market for the subsequent private placement offering. This may potentially increase risks to any non-accredited investors participating in the subsequent private placement offering if such investors rely on the information communicated through general solicitation because private placement offerings do not afford the same investor protections as, for instance, Regulation A and Regulation Crowdfunding.”³⁶

In short, this is not a minor technical change. Rather, it would have real impacts on markets, including reducing the incentive for companies to go public. Allowing issuers to mix and match serial, substantially similar exempt offerings in perpetuity could result in issuers' being able to raise unlimited amounts of money from an unlimited number of investors, including by advertising and selling broadly to the general public, without ever needing to go through the registration process.³⁷ This is precisely what the integration doctrine seeks to prevent. It would deprive investors and the market of all the benefits associated with a registered offering.³⁸

³⁵ This includes information about who the issuers are in Reg. D markets, who the investors are who buy Reg. D offerings, 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, 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. *See, e.g.*, Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

³⁶ Release at 184-185.

³⁷ Letter from Christopher Gerold, NASAA, to the SEC, October 11, 2019, <https://bit.ly/2XSaPs2> (“This would further encourage companies to use private securities transactions and avoid going public.”); *See also* Karen Tyler, NASAA, to the SEC, October 26, 2007, <https://bit.ly/3gM34MS> (“[I]t would allow issuers to conduct more offerings without registration and the protections afforded investors through the registration process.”).

³⁸ Letter from Erik F. Gerding, et. al., to the SEC, September 24, 2019, <http://bit.ly/2ombOKO> (“Public markets represent the gold standard for investor protection and capital formation,” including by providing mandatory disclosure, remedies, and oversight, while private markets in contrast, have information asymmetry, liquidity risk, dilution risk, and lack of recourse); *See also* Letter from Tyler Gellasch, Association, to the SEC, September 30, 2019, <https://bit.ly/3dusegT> (“The regulatory regime provided by the registration and ongoing reporting obligations of the Securities Act and the Exchange Act performs essentially two critical, but distinct functions: 1. It ensures that key information about securities, including issuer governance, operations, and financials are widely available, so that market participants can accurately assess the value of the securities and allocate capital efficiently; and 2. It levels the playing field between investors and issuers, as well as between different types of investors, by ensuring

NASAA raised these concerns in its comment on the Concept Release, but they got short shrift from a Commission that seems to have little interest in hearing opposing views. While industry arguments in support of the proposed changes are given careful attention in the proposing release, the release relegates NASAA's concerns to a "*But see*" reference buried deep in a footnote.³⁹ Where comments from industry supporters are accorded great deference, the Release characterizes NASAA's letter as "positing" that "loosening" integration safe harbors would "increase the likelihood of regulatory arbitrage or create gaps in the investor protection landscape."⁴⁰ It is worth noting that in 2007, a Republican Commission acknowledged these same concerns and took them more seriously, stating, "While we recognize the burdens that the integration doctrine places on capital formation, improper reliance on exemptions from registration harms investors by depriving them of the benefits of full and fair disclosure and the civil remedies that flow from registration."⁴¹

Gutting the integration doctrine would also have a real impact on retail investors. According to PIABA's comment on the Concept Release, which like NASAA's comment was relegated to a brief mention in the footnotes in the proposal, relaxing the integration doctrine "would unquestionably cause retail investors harm."⁴² PIABA described how "members' clients have repeatedly fallen victim to Ponzi schemes whereby a continual stream of unregistered securities is offered, with each new offering funding the payoff of an older, maturing one. Registration is avoided by carefully minding the six-month measure."⁴³ PIABA further noted that just such a scheme was used by the promoters behind the Medical Capital fraud, in which promoters used a series of private offerings to raise billions of dollars. "Shortening that period will undoubtedly serve to promote those Ponzi schemes, allowing unscrupulous issuers to issue a never-ending stream of securities to fund older issues," PIABA wrote. "The schemes will run well for a while if the wrongdoers know they will have access to fresh capital every thirty or ninety days. The constant inflow will provide a stream of 'returns' to the early investors – which streams will be used to promote the future offerings and thereby bring a host of new victims into the scheme. This is, effectively, how all Ponzi schemes work and reducing the time period between these issuances will only serve to hurt more investors."⁴⁴ The Commission provides no justification for its decision to dismiss this concern, or even any serious analysis of the issue.

The Commission includes an additional broad safe harbor for any and all offers and sales made in reliance on an exemption for which general solicitation is permitted so long as they are made "subsequent to any prior terminated or completed offering."⁴⁵ In this case, no cooling off period is required. The Commission justifies this rollback on the grounds that integration of these

that all investors -- not just those with market power or access -- have access to key information in a timely manner.").

³⁹ Release at 26, note 56.

⁴⁰ *Id.*

⁴¹ Proposed rules and Request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828; IC-27922; File No. S7-18-07, August 3, 2007, <https://bit.ly/3csZLXB>.

⁴² Letter from Christine Lazaro and Samuel Edwards, Public Investors Advocate Bar Association ("PIABA"), to the SEC, September 24, 2019, <https://bit.ly/36Rzsc0>.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 53.

types of offerings is not “necessary to further investor protection.”⁴⁶ Specifically, the Commission argues that those exemptions that allow general solicitation have their own protections. For example, an offering pursuant to Reg. A or Reg. CF would provide investors in these offerings with an offering document and ongoing disclosures, and an offering pursuant to Rule 506(c) of Reg. D would require issuers to take reasonable steps to verify that all investors in the offering are accredited investors, who are deemed to be sophisticated investors who do not need the protections of Securities Act registration. We believe the Commission’s justification is myopic and wrong for several reasons.

First, the Commission has no basis for claiming the protections for exemptions allowing general solicitation are sufficiently protective. For example, the Commission has no basis to conclude that 506(c)’s verification requirement provides any reasonable assurances that only accredited investors purchase such offerings, particularly if it adopts changes proposed separately in this release to further relax the verification requirements. Similarly, the Commission fails to acknowledge extensive evidence of fraud in the Reg. A market and widespread non-compliance in the Reg. CF market, which we discussed in our comments on the Concept Release and discuss further below.⁴⁷ The Commission’s refusal to engage with this issue further reflects the complete lack of attention to investor protection concerns evident throughout this release.

Second, the proposed safe harbor is further evidence that, far from proposing technical changes to simplify the integration regime, the Commission’s actual intent is to overturn the underlying purpose of the integration doctrine -- preventing issuers from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that the resulting offerings would qualify for Securities Act exemptions that would not be available for the combined offering. For the same reasons discussed above, allowing issuers virtually unlimited ability to combine their use of different exemptions makes it less likely issuers would need to engage in a registered offering. Investors in those offerings would not get the full benefits and protections that they would receive from a registered offering. Thus, allowing issuers to mix and match different exemptions would deprive investors of those important benefits.

The release acknowledges that the proposed changes to the integration framework are designed to encourage the use by issuers of multiple offerings using multiple exemptions without having to register any of those offerings. This is a tacit admission that the Commission is seeking to do an end-run around the integration doctrine, defeating its original purpose. The release states, for example, that it would “promote the use of exemptions by issuers that undertake multiple offerings” and address the “inability to attract sufficient capital through a single offering method.”⁴⁸ It further states that “the flexibility may be especially valuable in cases where one or more of the exempt offerings conducted by an issuer is subject to offering limits, as well as in cases where an issuer conducts multiple offerings that are subject to different solicitation, disclosure, offering size, or investor requirements.”⁴⁹ Thus, the Commission is being transparent about the fact that it wants issuers to be able to mix and match different offering exemptions to

⁴⁶ *Id.*

⁴⁷ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

⁴⁸ Release at 182.

⁴⁹ *Id.* at 183.

effectively undertake one larger financing arrangement, the precise conduct the integration doctrine was intended to disallow.

The Commission acknowledges, but dismisses as unimportant, concerns that the proposed amendments risk harming investors and depriving them of the benefits of the registration requirements. It states, for example, that it “could result in additional financing being raised from non-accredited investors without registration requirements.”⁵⁰ It further acknowledges that, “The disclosure requirements of all of these exemptions are less extensive than the requirements associated with a registered offering, which may in some cases lead to a weakening of investor protections.”⁵¹ Unperturbed by these investor protection concerns, the Commission proceeds anyway, putting its thumb on the scale in favor of issuers’ interests and disregarding retail investor interests.

Instead of gutting the integration doctrine, as it proposes to do here, the Commission should undertake a study of whether and how its current approach to integration is a factor in the decline of public markets and whether and how it puts investors at risk. Based on that analysis, the Commission should reconsider its approach, with an eye toward reversing the relaxation of the integration doctrine that has occurred in recent years. Doing so should have the added benefit of considerably simplifying the current complex and inconsistent regime.

B. Allowing issuers greater ability to communicate with the public about potential exempt offerings makes a mockery of the notion of “private” offerings.

Not satisfied with eviscerating the integration doctrine, the Commission also proposes to eliminate the few remaining restrictions on general solicitation and advertising in ostensibly “private” offerings. It proposes to do so, first, by allowing unrestricted participation in “demo days,” which clearly constitute general solicitation, for offerings under Rule 506(b), where general solicitation is specifically prohibited. The Commission’s only apparent justification for this proposed change is its “understand[ing]” that it “may not be practical for the organizer of the event to limit participation” to individuals or groups with whom the issuer or the organizer has a pre-existing substantive relationship or that have been contacted through a group of financially sophisticated individuals, such as an angel investor group.⁵² Second, the Commission proposes to expand issuers’ ability to test the waters (solicit indications of interest) across all exempt offerings, including by permitting issuers to engage in such activities prior to determining which exemption they will rely on to conduct the offering. We strongly oppose both proposed changes.

1. The rule would exempt demo days from the prohibition on general solicitation with minimal, ineffective safeguards, despite the fact that demo days clearly constitute general solicitation.

Although Congress did not clearly define what it meant by “transactions not involving a public offering,” the House Committee Report made clear that the intent was to provide only a narrow exemption “to permit an issuer to make a specific or an isolated sale of its securities to a

⁵⁰ *Id.* at 184.

⁵¹ *Id.*

⁵² *Id.* at 65.

particular person.”⁵³ While Congress and the Commission have dramatically expanded that interpretation over the years, the Commission long held that general solicitation and advertising were largely incompatible with a “private” offering. As Commissioner Herren Lee explained: “Historically, general solicitation has been permitted in our public markets because offerings in that market carry the protections of registration and robust disclosure requirements. By contrast, in the private markets where those protections are largely absent, general solicitation has been carefully limited and, for some exempt offerings, banned.”⁵⁴

With passage of the JOBS Act, however, Congress “[took] a hatchet to the nonpublic offering exemption,” as University of Mississippi Professor of Law Mercer Bullard explained in 2018 testimony before the Senate Banking Committee.⁵⁵ It did so by requiring “the SEC to authorize general solicitation and advertising under the nonpublic offering exemption despite the fact that these were inherently incompatible concepts . . . In other words, although general solicitation and advertising are quintessentially ‘public’ in nature, Congress chose to cram the square peg of an essentially public offer into the round hold of the nonpublic offering exemption (under the Orwellian header ‘Consistency in Interpretation’),” Bullard stated.⁵⁶

The Commission now proposes to expand on this Orwellian approach by adopting a new Rule 148 providing that certain “demo day” communications would not be deemed general solicitation or general advertising so long as the organizers comply with minimal conditions outlined in the proposed rule. These conditions closely track provisions of a Senate bill that Bullard described as “the de facto repeal of offering regulation.”⁵⁷ We agree. Like the legislation on which it is based, the proposed rule would allow a wide range of entities “to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering.”⁵⁸ And, like the bill, the proposed rule “purports to require that ‘no specific information regarding an offering of securities by the issuer [be] communicated or distributed by or on behalf of the issuer,’ and then creates an exception that covers all of the essential specific information that an issuer would want to communicate regarding its offering.”⁵⁹

In short, the Commission is proposing to declare that general solicitation in the form of demo days open to any and all investors isn’t really general solicitation for regulatory purposes. Its goal is to further expand issuers’ ability to market their offerings to the general public without having to provide the transparency Congress sought to ensure when it adopted the ’33 Act. This is particularly troubling when combined with the above discussed evisceration of the integration doctrine, the proposed expansion of test-the-waters communications to unsophisticated investors in private offerings, and the proposed weakening of accredited investor verification requirements discussed below. Moreover, since demo days won’t be considered “general solicitation,” this

⁵³ H.R. Rep. No. 73-85 at 15-16 (1933).

⁵⁴ Commissioner Herren Lee Statement.

⁵⁵ Testimony of Mercer E. Bullard, Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, “Legislative Proposals to Increase Access to Capital,” June 26, 2018, <https://bit.ly/2AzCq9a>.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

seems to suggest that investors identified through such demo days wouldn't be considered to have been identified through general solicitation for the purposes of determining which integration safe harbor restrictions would apply. In short, this proposal is ripe for abuse. Given the Commission's record of lax enforcement of Form D filing requirements, there is no reason to believe that the Commission would provide the extensive level of oversight and enforcement necessary to prevent such abuses.

Finally, the Commission offers no evidence to support its stated justification for the proposal, that the current restrictions impose an unreasonable barrier to organizing such events, or its purported benefits, that it will disproportionately help entrepreneurs who have traditionally struggled to attract financing, such as women and minorities. A quick Google search turns up several examples of demo days that are apparently successfully organized under the existing restrictions.⁶⁰ Among these are demo days designed specifically for startups with minority and women founders, again operating successfully within the existing requirements.⁶¹ Indeed, if their websites are to be believed, they are more likely to be over-subscribed, and turning away potential investors, than struggling to attract interest under the existing regulations.

Second, there is no evidence that, if the Commission were to loosen the restrictions on demo days, women and minority entrepreneurs who have struggled to attract financing would benefit. On the contrary, research from Wharton management professor Laura Huang suggests that the pitch format of attracting investors may exacerbate an inherent bias that favors investing in companies run by men.⁶² She found, for example, that the same business pitched with a man's voice got considerably more interest than when it was pitched with a woman's voice. As the author of a *TechCrunch* article on the questionable benefits of demo days stated, "For entrepreneurs who don't pitch well — or who don't fit investors' mental image of a successful entrepreneur — Demo Days may hurt more than they help. ... The Demo Day format is not ideal for investors, either. If you're picking who pitches best, not who runs the best business, you're not getting the best results."⁶³ At the very least, the Commission should not blindly assume its proposed approach will deliver the promised benefits without testing its assumptions against reality. There are reasons to be skeptical. As the author of the *TechCrunch* article concluded, "over time, we've learned that Demo Days aren't actually accomplishing what they're supposed to: helping entrepreneurs raise money and meet investors."⁶⁴

The Commission's breezy assurance that the limitations included in the proposal would adequately protect investors is similarly without foundation. If there is evidence to support these assumptions, the Commission has failed to provide it. Before it moves forward with a proposal

⁶⁰ See, e.g., Y Combinator, Demo Days FAQ, <https://www.ycombinator.com/demoday/faq/#p2> (last visited May 30, 2020) (providing instructions on how to get an invitation to Y Combinator's twice annual invitation-only demo days); See also 500 Startups Demo Day, <https://500.co/demo-day-register/> (last visited May 30, 2020).

⁶¹ Press Release, KiwiTech, "KiwiTech to Host First Online Version of its Minority Founders Demo Day," May 13, 2020, <https://bit.ly/2U32fp8>; KiwiTech, KiwiTech Presents Female Founders' Demo Day 5.0, San Francisco, February 27, 2020, <https://bit.ly/2MpTu4l> (last visited May 30, 2020); Taylor Soper, Female Founders Alliance Demo Night: 8 women-led startups pitch their businesses, GeekWire, October 18, 2019, <https://bit.ly/302B0is>.

⁶² Ross Baird, Why this investor is ditching Demo Days, TechCrunch, March 4, 2017, <https://tcrn.ch/3crwexh> (citing Knowledge @ Wharton, University of Pennsylvania, Who's the Most Attractive Investment Opportunity of All? Good-looking Men, May 26, 2015, <https://whr.tn/3co4ZUX>).

⁶³ *Id.*

⁶⁴ *Id.*

that would dramatically weaken restrictions on general solicitation in Rule 506(b) offerings, the Commission should provide actual evidence that a problem exists that requires a regulatory response and that its proposed approach is consistent with the Commission’s investor protection mandate. A top priority should be examining how the relaxed requirements for demo days would work in combination with weakened integration requirements, expanded test-the-waters communications, and weakened accredited investor verification standards, how investors could be harmed, and what resources would be needed for oversight and enforcement to prevent that harm. The latter point is particularly important, since the Commission to date hasn’t been willing or able to devote the resources necessary to prevent abuses in the Reg. D market, rendering its proposal all the less defensible.

2. The rule would allow test-the-waters communications across all exempt offerings, effectively eliminating any pretense that “private” offerings are actually private and putting financially unsophisticated retail investors at risk.

Potentially even more damaging than the Commission’s proposal to exempt demo days from restrictions on general solicitation is its related proposal to allow test-the-waters communications for all exempt offerings. The Commission proposes to do this by adopting a new Rule 241 that would permit an issuer to use generic solicitation of interest materials for an offer of securities prior to determining which exemption to rely on for the offering. As Commissioner Herren Lee stated, this would “effectively permit general solicitation prior to any type of exempt offering.”⁶⁵ As Professor Bullard said in a different context, it would “take a hatchet to the nonpublic offering exemption.”⁶⁶

The Commission is proposing this sweeping expansion of general solicitation in private offerings without providing any meaningful investor protections. For example:

- Unlike the existing testing-the-water rule for registered companies, issuers taking advantage of the new Rule 241 would be free to test the water not just with sophisticated institutional investors, or even supposedly sophisticated individual accredited investors, but also with financially unsophisticated retail investors.
- The communications would be required to carry a boilerplate disclaimer but would not be required to provide any meaningful warnings of the risks associated with private offerings generally or the risks of the specific offering.
- While issuers would not be able to rely on the generic test-the-waters rule once they had chosen which exemption to rely on, there’s nothing in this requirement to prevent issuers from pretending to be undecided, in order to take advantage of the new rule, then announcing their predetermined decision regarding which exemption to rely on.
- The rule’s provisions to restrict the use of test-the-waters communications with offerings, such as Rule 506(b) offerings, that do not permit general solicitation, are both easily gameable and difficult to police.

⁶⁵ Commissioner Herren Lee Statement.

⁶⁶ Testimony of Mercer E. Bullard, Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, “Legislative Proposals to Increase Access to Capital,” June 26, 2018, <https://bit.ly/2AzCq9a>.

In a nod toward investor protection, test-the-waters communications would be subject to anti-fraud provisions of the federal securities laws. However, the protections this provides are more theoretical than real. Given the Commission's enforcement record in the Reg. D market, there's no reason to believe that those provisions would be enforced effectively. This is particularly true since, for the most commonly used of the offering exemptions, Rule 506(b), the Commission proposes to allow issuers to use offering materials for test-the-waters communications that wouldn't even have to be filed with the Commission. As a result, the Commission would have no advance warning of fraudulent activities.

The only good aspect of the proposal is that it would not preempt state authority, something that is sure to come under attack from industry commenters. If the Commission insists on moving forward with the anti-investor proposal, which we strongly oppose, the least it can do is preserve state oversight authority, since it is the state regulators that provide the bulk of the regulatory oversight in the private markets. Even so, without a requirement for test-the-waters communications to be filed with the Commission for Rule 506(b) offerings, they will be operating blind-folded and with one hand tied behind their back. Indeed, as Commissioner Herren Lee explained in her statement, the proposed approach “presents challenges for enforcement of registration violations and violations of existing prohibitions against general solicitation for state regulators.”⁶⁷

As with other proposals included in this release, the Commission has provided no evidence of a genuine problem demanding a regulatory solution, aside from the fact that it appeared on some industry wishlist, to justify this sweeping deregulatory proposal. And its statements of the proposal's purported benefits for investors are completely unfounded. Suggesting, as the Commission does here, that average retail investors will have the ability “to have input into the structuring of the offering” and “to convey to the issuer the types of information about which they are most interested,” thus resulting in “more investor-friendly deal terms,”⁶⁸ is either inexcusably naive or incredibly cynical. Indeed, the precise reason the Commission chose to limit test-the-waters communications in the registered offering context to Qualified Institutional Buyers (QIBs) and Institutional Accredited Investors (IAIs) is their recognition that these large, sophisticated institutional investors have an ability to “fend for themselves” that retail investors lack.⁶⁹ In adopting that earlier regulation, the Commission acknowledged that there were potential adverse effects on investors of expanding test-the-waters communications, but concluded that these could be mitigated by limiting communications to QIBs and IAIs. As the Commission stated in the proposing release for the test-the-waters rule for registered offerings, QIBs and IAIs are “generally considered to have the ability to assess investment opportunities, thereby reducing the need for the additional safeguards” provided by a

⁶⁷ Commissioner Herren Lee Statement. This also presents challenges for enforcement of registration violations and violations of existing prohibitions against general solicitation for state regulators. *See, e.g.*, Letter from A. Heath Abshire, NASAA, to the SEC, October 3, 2012, <https://bit.ly/3dsIUp8> (discussing the difficulty of policing offerings given the increased availability of general solicitation especially in light of the limitations of Form D, saying an “investigator who sees an advertised offering will have no simple way of knowing whether the issuer is engaged in a compliant Rule 506 offering or is merely advertising an unregistered, non-exempt public offering.”).

⁶⁸ Release at 71.

⁶⁹ Final Rule, Solicitations of Interest Prior to a Registered Public Offering, Release No. 33-10699, File No. S7-01-19, September 25, 2019, <https://bit.ly/3gIOwgW>.

filing requirement.⁷⁰ The same cannot be said for average retail investors (or even most individual accredited investors).

The Commission justifies its decision to open up such communications to retail investors generally on the grounds that “there is likely to be relatively limited institutional investor interest in many types of exempt offerings, particularly those that rely on general solicitation. In addition, small or emerging businesses are likely to face challenges in attracting significant institutional investor interest, either directly or through an underwriter or other intermediary.”⁷¹ While this may be true, it doesn’t justify a proposal that poses significant risks to retail investors. Instead, it offers a sound reason for scrapping the proposal in its entirety. There could be many reasons institutional investors are uninterested in investing in such offerings, one of which may be their belief that few such offerings represent a good value. Instead of considering this basic question, the Commission has chosen to ignore any such concerns and instead make it easier to push these potentially inferior offerings to financially unsophisticated retail investors.

The Commission cites the experience with test-the-waters communications under Reg. A as evidence that the concept can work with retail investors. But, as we discussed at some length in our comment letter on the Concept Release, the Reg. A market has been rife with fraud precisely because it allows direct communication between issuers and investors.⁷² As the *Wall Street Journal* noted in an article last year, Reg. A+ has been “tainted by poor post-IPO performance and concerns about fraud.”⁷³ In a 2019 post, Renaissance Capital referred to Reg. A+ as “the wild west of IPOs.”⁷⁴ The results have been harmful for both investors and legitimate issuers. 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”: “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. 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.’”⁷⁵ 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.”⁷⁶ There’s nothing in the Commission’s proposed expansion of general solicitation to

⁷⁰ Proposed Rule, Solicitations of Interest Prior to a Registered Public Offering, Release No. 33-10607, File No. S7-01-19, February 19, 2019, <https://bit.ly/3dsQAaL>.

⁷¹ Release at 76-77.

⁷² Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

⁷³ Alexander Osipovich, Exchanges Shy Away From Mini-IPOs After Fraud Concerns, *Wall Street Journal*, June 10, 2019, <https://on.wsj.com/2lrPWET>.

⁷⁴ 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.).

⁷⁵ Matthew Smith, Reg. A+ has failed both investors and startups: one founder’s experience, *Medium*, April 9, 2018, <http://bit.ly/2lQFUNP>.

⁷⁶ *Id.*

all private offerings, through its test-the-waters-communications proposal, to prevent this same “wild west” style from infecting the entire exempt offering space.

The Commission also proposes to allow expanded use of test-the-waters communications in the crowdfunding market, based on the same absurd contention that it would enable investors to “have input into the structuring of the offering” and to “convey to the issuer the types of information about which they are most interested.”⁷⁷ It is notable that the Commission would even allow oral test-the-waters communications in a market where the central feature is supposed to be that it is entirely online. Moreover, in proposing this approach, the Commission ignores evidence that crowdfunding has, since its inception, been characterized by a “culture of noncompliance,” as discussed in detail in both our comment letter on the Concept Release and in research by Professor Bullard.⁷⁸ Bullard analyzed a sample of 362 crowdfunding offerings and evaluated compliance with some of Reg. CF’s most basic requirements. 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.

Given this poor record of compliance with the most basic requirements of Reg. CF, there’s every reason to believe that the Commission’s proposal to relax restrictions on test-the-waters communications in the crowdfunding market would put investors at risk. At best, it would open up new opportunities for selective disclosure, at worst it would create new opportunities for difficult-to-police fraud. In between, it is sure to lead to inadvertent violations by the unsophisticated issuers that have been attracted to the crowdfunding markets. In short, there are good reasons why crowdfunding communications should be restricted to communications through portals, both before and after Form C is filed with the Commission. Communications conducted outside the portal will be impossible to police. That is simply not an acceptable risk in a market that is already characterized by a culture of noncompliance that the Commission has proven itself unable or unwilling to police.

In both the Commission’s generic test-the-waters proposal and its crowdfunding-specific proposal, the investor benefits are strictly fictional, while the risks of abuse are very real. Indeed, the Commission itself acknowledges (albeit buried in the economic analysis) that its proposal “might lead investors to make less informed investment decisions,” if they rely on materials distributed through test-the-waters communications rather than the offering circular in making their investment decision.⁷⁹ “For example, if the information conveyed through test-the-waters communications is an incomplete representation of the risk of an offering, and if investors fail to read the subsequent offering circular before making the investment decision, they might make a less informed investment decision. These investor costs might be exacerbated to the extent that investors in Regulation Crowdfunding offerings are likely to be small and relatively less

⁷⁷ Release at 79.

⁷⁸ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY> (citing Mercer Bullard, *Crowdfunding's Culture of Noncompliance: An Empirical Analysis*, 24 *Lewis & Clark L. Rev.* __ (forthcoming 2020), <http://bit.ly/2l8Upfv>).

⁷⁹ Release at 199.

sophisticated and thus less equipped to process information contained in test-the-waters communications.”⁸⁰ The Commission then dismisses these concerns on the grounds that those “unscrupulous issuers” who “might seek to disseminate misleading information through test-the-waters communications,” are probably already engaged in misleading communications in violation of antifraud provisions.⁸¹ As noted above, however, the Commission has shown itself to be either unable or unwilling to prevent such fraud; it should not now make it easier to commit.

For all the above reasons, the Commission should scrap both the generic test-the-waters proposal and the crowdfunding-specific proposal in their entirety. The Commission’s hope that its proposals would “facilitate capital formation,” unbacked as it is by any data, is not a sufficient basis to abandon a fundamental principle of private offerings -- that they should be private.

C. The proposal would weaken Rule 506(c) verification requirements, increasing the likelihood that general solicitation is used to sell to non-accredited investors.

The Commission’s proposals regarding demo days and test-the-waters communications greatly expand the risk that private offerings will be marketed to non-accredited investors. As such, if the Commission insists on moving forward with these ill-advised proposals, the very least it should do is strengthen the requirements designed to ensure that issuers’ practices to verify accredited investor status are effective and rigorously enforced. Instead, it sends the opposite message in this release, by proposing both to weaken existing verification requirements and by sending the message that it may be prepared to look the other way when issuers adopt weak verification practices.

In drafting Section 201(a) of the JOBS Act, which directed the Commission to promulgate rules that permit general solicitation in Rule 506 offerings, Congress was clear that use of general solicitation came with restrictions. Specifically, it could only be used where “all purchasers of the securities are accredited investors.” The section also specified that rules adopted by the Commission to implement general solicitation “shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission.”⁸²

In adopting its general solicitation rule, the Commission made both the requirement to ensure that all purchasers are accredited investors and the requirement to take reasonable steps to verify purchasers’ accredited investor status explicit in the rule. The Commission explained that “the purpose of the verification mandate is to address concerns, and reduce the risk, that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors.”⁸³ The Commission further clarified that the verification requirement “is separate from and independent of the requirement that sales be limited to

⁸⁰ *Id.*

⁸¹ Release at 200.

⁸² Pub. L. No. 112-106, 126 Stat. 306 (2012).

⁸³ Final rules, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12, July 10, 2013, <https://bit.ly/370vGxl>.

accredited investors, and must be satisfied even if all purchasers happen to be accredited investors.”⁸⁴

Despite the legitimate concerns it expressed about the need for rigorous verification practices, the Commission today apparently has no knowledge about whether existing verification methods provide any reasonable assurances that only accredited investors purchase such offerings. Nor does the Commission appear to know whether, in the typical Rule 506(c) offering, all purchasers of such offerings are in fact accredited investors. Certainly, it provides no evidence on these key issues in this release. This suggests that the Commission not only doesn’t know whether existing practices comply with the law, but also that it is not making any concerted effort to find out.

Assessing the adequacy of and compliance with existing verification practices ought to be the starting point for any regulatory proposal to adjust those requirements. Instead, the Commission is proposing to relax the 506(c) verification requirement in a way that would increase the likelihood that 506(c) offerings are sold to non-accredited investors. Specifically, the Commission is proposing to allow an issuer to rely on self-certification to establish that an investor for which the issuer previously took reasonable steps to verify as an accredited investor remains an accredited investor as of the time of a subsequent sale. In such cases, the investor would merely be required to provide a written representation to that effect, and the issuer could rely on that representation as long as it is not aware of information to the contrary. We have no doubt that this would result in Rule 506(c) offerings’ being sold to non-accredited investors. Certainly, the Commission offers no evidence to refute that concern, and its lack of effective enforcement of existing verification requirements reinforces that concern.

The Commission justifies this provision on the grounds that it would “reduce the cost and burden of verification for issuers that may opt to engage in more than one Rule 506(c) offering over time.”⁸⁵ It further suggests that “[i]nvestors’ privacy concerns may also be alleviated, because they would not be asked to repeatedly provide financially sensitive information to the issuer.”⁸⁶ Finally, the Commission claims that “the risk of investor harm would be mitigated by the pre-existing relationship between the issuer and such investor.”⁸⁷ The Commission fails to provide any evidence that verification requirements impose unreasonable costs or burdens. It fails to provide any evidence that investors’ privacy concerns related to verification practices are limiting their willingness to participate in multiple offerings with the same issuer. Nor does it provide any evidence to support its claim that the risk of harm would be mitigated by the pre-existing relationship. Supporting these claims would require knowledge of practices in the Reg. D market that the Commission lacks and has been unwilling to seek, in a deliberate disregard for its professed commitment to fact-based, data-driven rulemaking.

In reality, the Commission’s proposed approach does not provide reasonable assurances that all investors who purchase Rule 506(c) offerings will be accredited for several reasons discussed below. As such, it does not comport with the purpose that the Commission outlined in

⁸⁴ *Id.* at 26.

⁸⁵ Release at 88.

⁸⁶ *Id.*

⁸⁷ *Id.*

the 506(c) adopting release, which was to “address concerns, and reduce the risk, that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors.”⁸⁸ On the contrary, this proposed approach would increase, not reduce, that risk.

First, an investor’s ability to meet the financial thresholds that determine whether they are accredited can and does change over time. Someone who meets the income, but not the net worth, threshold one year, for example by making \$200,000, may then retire or take a lower paying job and thus no longer qualify as an accredited investor. Or a couple that qualifies based on their combined income of \$300,000 may cease to qualify if one of the partners stops working. Similarly, an investor could have \$1 million in savings to qualify as an accredited investor and be able to invest in a private offering, but then cease to meet the threshold in subsequent years because they used a portion of their money to buy a house, faced significant costs related to an illness, experienced a business setback, or suffered significant losses on their investments. This is all the more likely because many years could pass between the initial verification and the subsequent investment under the Commission’s proposed approach, years in which an investor’s circumstances could change considerably. This risk is particularly pronounced if the investor barely met the accredited investor financial thresholds in the first place. But, under the Commission’s proposed approach, as long as that investor fails to affirmatively inform the issuer of her changed circumstances, either because she doesn’t understand how her changed circumstances impact her accredited investor status or because she is seeking to circumvent the rules, and as long as the issuer can plausibly deny knowing of the change, the issuer would be free to sell to that investor in a Rule 506(c) offering without taking further verification steps.

The Commission’s proposed approach reflects a willful ignorance of the extent to which people’s financial circumstances change. It is equivalent to suggesting that a person who once gets tested for COVID, and that test comes back negative, could reasonably be assumed to be COVID-free two weeks, two months, or two years from now. If the Commission had bothered to study the Reg. D market, it might have a reasonable basis for determining the extent to which investors move in and out of accredited investor status, and that knowledge could inform its proposed approach. But on this, as on so many other issues relevant to this rule proposal, the Commission refuses to examine the facts that may conflict with its proposed regulatory approach, preferring instead to rely on anecdotal self-serving assertions from industry participants and its own unfounded suppositions that existing regulatory protections are adequate.

In this case, for example, the Commission bases its finding that the rule adequately protects investors on the existence of a pre-existing relationship between an issuer and investor, but such relationships may be quite superficial and fleeting. The mere fact that the investor purchased from the issuer in the past says nothing about their ability to qualify as accredited currently. Moreover, an investors’ written assurances do not adequately ensure that she meets the qualification requirements. For example, the Commission cannot reasonably assume that investors will know whether they meet the financial thresholds in the definition. An investor who

⁸⁸ Final rules, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12, July 10, 2013, <https://bit.ly/370vGxl>.

is under the misapprehension that they meet the requirements because they miscalculated their net worth could unknowingly provide a false certification. Or the investor could state that they meet the thresholds when they know they do not in order to participate in what they perceive as an investment with “high-growth potential.” In either case, nothing in the Commission’s rule proposal would prevent the inappropriate sale, as long as the issuer can plausibly deny knowing that the investor’s self-certification is inaccurate. Indeed, the Commission’s proposed approach encourages issuers to turn a blind eye in order to avoid learning the facts.

Moreover, this proposal entirely disregards the independent condition under 506(c), that all purchasers must be accredited investors. The Commission acknowledges, albeit with apparent indifference, that this condition will probably not be met, stating: “[W]e recognize that some previously verified investors that lose accredited investor status over time might provide written representations that they are accredited investors, and if issuers are not aware of information to the contrary, such issuers might sell securities to those non-accredited investors under Rule 506(c).”⁸⁹ Rather than determine that this increased possibility renders the proposal insufficiently protective of investors, unworkable, and not in accordance with congressional mandates, the Commission proceeds anyway. Even more troublingly, if and when 506(c) offerings are sold to non-accredited investors, the Commission will have no way of knowing that this has occurred, because of its own inadequate oversight of this market, and won’t be able to take action for violation of the terms of the exemption. As a result, this proposal effectively condones the use of general solicitation to sell to non-accredited investors.

This impression is reinforced by a related provision in the proposal, which encourages issuers to rely on the principles-based method of verification and equates reasonable steps with reasonable belief. Specifically, the Commission states: “We are of the view that, in some circumstances, the reasonable steps determination may not be substantially different from an issuer’s development of a ‘reasonable belief’ for Rule 506(b) purposes. For example, an issuer’s receipt of a representation from an investor as to his or her accredited status could meet the ‘reasonable steps’ requirement if the issuer reasonably takes into consideration a prior substantive relationship with the investor or other facts that make apparent the accredited status of the investor.”⁹⁰ For all the reasons outlined above, this is not a valid approach. Moreover, because it falsely equates verification with reasonable belief, this is likely to be interpreted as a loosening of current verification requirements. This is particularly true, coming as it does in the context of a release the overwhelming message of which is “anything goes” when it comes to marketing private offerings to retail investors. For all these reasons, the Commission should withdraw its proposed anti-investor changes to the accredited investor verification requirements for Rule 506(c) offerings.

D. Allowing crowdfunding investors to invest through an SPV would render Section 12(g) of the Exchange Act, one of the only remaining mechanisms to push private companies into public markets, even less applicable and relevant.

Crowdfunding is based on a deeply flawed concept that makes it an unattractive investment option for investors and issuers alike. The small retail investors who participate in

⁸⁹ Release at 209.

⁹⁰ *Id.* at 90-91.

crowdfunding offerings lack the financial sophistication or market power to negotiate the same kind of favorable terms -- such as protections against dilution -- that larger, institutional investors typically demand when providing early stage funding. They also typically lack the financial sophistication necessary to determine whether the shares being offered are fairly valued. As a result, even if they have the good fortune to identify a crowdfunding issuer with a winning idea, they may not benefit from that company's future success. Issuers, meanwhile, don't like the messy capitalization table that results when they get their early funding from a large number of very small investors.

The Commission proposes to "solve" these problems by adopting a new rule to permit the use of special purpose vehicles ("crowdfunding vehicles") to serve as conduits to invest in businesses raising capital under Regulation Crowdfunding. In order to provide the desired "simplification" of the capitalization table, however, the Commission proposes to treat these new crowdfunding vehicles as a single record holder for purposes of Section 12(g), rather than treating each of the crowdfunding vehicle's investors as record holders as would be the case if they had invested in the crowdfunding issuer directly. A side effect of this proposal, whether unintentional or otherwise, is that it would further undermine transparency of private offerings and further erode incentives private companies have to become public companies once they have acquired a large and widely dispersed shareholder base.

Section 12(g) requires an issuer with total assets of more than \$10 million and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, to register that class of securities with the Commission. The purpose of this rule is to ensure that companies that have reached a certain asset size and gained a widely dispersed shareholder base make basic public disclosures about their governance, operations, and finances.⁹¹ As such, Section 12(g) of the Exchange Act is one of the few remaining mechanisms to push private companies into public markets, since companies that are required to become publicly reporting companies under the '34 Act often choose to take the next step and register their offerings under the '33 Act.

The existing regulation already reflects a substantial weakening of the 12(g) threshold that had been in place for decades, and as such likely explains the rapid growth of so-called "unicorns," companies that attain a valuation of at least \$1 billion in private markets, since the JOBS Act was enacted. Prior to the JOBS Act, companies were required to become publicly reporting companies once their securities were held of record by at least 500 persons. As a result, companies like Microsoft, Google and Facebook all went public as they approached the 500 shareholder limit that applied at the time. Investors enjoyed significant benefits, both because they got a chance to invest in these companies while they were still growing and because they benefited from the discipline that the greater transparency and stronger corporate governance standards of the public markets provide. According to Law Professor Renee Jones, "As these companies grew, and their shareholder base expanded, their founders understood they would

⁹¹ Congress intended to trigger '34 Act reporting requirements for companies with "sufficiently active trading markets and public interest." Reporting by Small Issuers, Exchange Act Release No. 23,407, 51 Fed. Reg. 25,369 (July 14, 1986).

soon face the glare of public scrutiny that came with an IPO” and adjusted their conduct accordingly.⁹²

The JOBS Act raised the threshold for holders of record. Companies can have up to 2,000 shareholders of record, including up to 500 non-accredited investors. With employees excluded from the shareholder count, this has allowed companies that grow to immense size with a large and widely dispersed shareholder base to stay private and avoid the transparency appropriate for such companies. Thus, a major mechanism both to discipline corporate behavior and to push private companies to become public companies has already been significantly weakened, relieving pressure on companies that would otherwise be approaching the previous trigger from going public. Investors lose out on the opportunity to invest in the companies while they are still growing without giving up the protections afforded in the public markets.

Not satisfied with the relaxation of 12(g) thresholds provided in the JOBS Act, the Commission provided additional relief in Regulation Crowdfunding for securities sold pursuant to 4(a)(6).⁹³ Specifically, Regulation Crowdfunding conditionally exempts securities sold pursuant to Section 4(a)(6) from the registration requirements of Section 12(g) if:

- the issuer is current in its ongoing annual reports required pursuant to Regulation Crowdfunding;
- has total assets as of the end of its last fiscal year of \$25 million or less; and
- has engaged the services of a transfer agent registered with the SEC.⁹⁴

If an issuer does not meet these three conditions, it cannot claim relief under this exemption under existing crowdfunding rules, and the general 12(g) thresholds would apply. For example, if an issuer had total assets of more than \$25 million or was not current on its ongoing annual reporting, thereby failing to meet the conditions of the Reg. CF exemption, it would be required to comply with the '34 Act reporting requirements.

Research by Law Professor Mercer Bullard suggests that the failure to meet these three conditions may be a frequent occurrence.⁹⁵ According to Bullard’s research, which analyzed a sample of 362 crowdfunding offerings, only 61 percent of the issuers he examined filed their mandatory initial annual report; only 37 percent filed it on time; and barely one quarter (28 percent) of issuers that were required to file two annual reports did so. According to Bullard, “Annual reports provide the only source of information about issuers’ post-offering conduct, but issuers routinely ignored that filing obligation.”⁹⁶ In short, Bullard’s research suggests that most

⁹² Written Testimony of Renee M. Jones, Professor of Law and Associate Dean for Academic Affairs, Boston College Law School, Before the House Financial Services Committee Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment,” September 11, 2019, <https://bit.ly/2zTRbnr>.

⁹³ Final Rule, Crowdfunding, Release Nos. 33-9974; 34-76324; File No. S7-09-13, October 30, 2015, <https://bit.ly/2yWQ4mx>.

⁹⁴ *Id.*

⁹⁵ Mercer Bullard, Crowdfunding's Culture of Noncompliance: An Empirical Analysis, 24 Lewis & Clark L. Rev. ___ (forthcoming 2020), <http://bit.ly/218Upfv>.

⁹⁶ *Id.*

crowdfunding issuers will not satisfy the conditions for the 12(g) exemption under Regulation CF because they are not current on their reporting obligations.

Given that crowdfunded securities are marketed and sold to non-accredited investors, it is quite possible that a successful crowdfunding issuer would hit the 500 non-accredited investor threshold, triggering the 12(g) reporting requirements. The Commission proposes to address this concern, not by improving compliance with Reg. CF, but by giving noncompliant crowdfunding issuers a new ability to avoid the reporting requirement. While the Commission is clearly aware of Bullard's research, having cited its existence in a "See also" reference in a footnote,⁹⁷ it is not clear whether the Commission has read the paper's findings and is indifferent to this evidence of noncompliance or, worse, whether its proposal is in fact motivated by its recognition that, because of their noncompliance, few crowdfunding issuers are likely to qualify for Reg. CF's exemption from 12(g).

The proposal would permit issuers to pursue a crowdfunded offering using a special purpose vehicle (SPV) so that they could sell to a "large and diffuse shareholder base" while maintaining a "simplified capitalization table."⁹⁸ Because the SPV would be considered a single record holder for purposes of Section 12(g), this would allow an issuer to sell to an unlimited number of investors, including an unlimited number of non-accredited investors, without those investors being considered record holders and therefore without having to worry about breaching the 12(g) thresholds. With this alternative available to them, crowdfunding issuers would have even less incentive to comply with Reg. CF's reporting requirements, to the detriment of investors. And crowdfunding issuers that do grow and prosper would have no obligation to provide the full and fair disclosure demanded under the '34 Act and little incentive to conduct an IPO, to the detriment of both investors and our public markets.

If the Commission believes there are benefits to investors of allowing them to invest in crowdfunding offerings through an SPV -- in essence acknowledging that crowdfunding as originally envisioned is unappealing to investors and issuers alike and unworkable in practice -- it should nonetheless require those investors who invest through such a vehicle to count as individual shareholders of record for the purposes of 12(g). We believe there are better ways to protect crowdfunding investors, as discussed below. And issuers that don't like the messy capitalization table that can result from conducting a crowdfunding offering have multiple other options available to them. What is clear, given the culture of noncompliance in the crowdfunding market, is that the last thing the Commission should do is adopt a change that would further erode incentives for compliance with Reg. CF reporting requirements, as the current proposal would do.

E. Increasing the offering and investment limits for various exemptions would allow companies to raise more money from investors through private offerings, to the detriment of investors and public markets.

The proposal would unjustifiably and inappropriately increase offering limits for Reg. A, Reg. CF, and Rule 504 offerings, and increase investment limits for Reg. CF, enabling issuers

⁹⁷ Release at 235, note 409.

⁹⁸ Release at 252.

who engage in these exempt offerings to raise more capital. The best that can be said for this proposal is that it is unlikely to significantly shift how funds are raised, given current market dynamics. However, to the extent it does increase the amount issuers can raise and investors can invest under these exemptions, that increase would likely come at the expense of vulnerable retail investors. Reg. A and crowdfunding offerings, in particular, appear to include a significant number of bad deals and scams that are marketed and sold to retail investors. Increasing the amount of retail investment that flows to these offerings can therefore be expected to cause these investors to suffer increased harm.

1. The proposal contravenes the will of Congress.

Without providing any evidence that doing so is either necessary or appropriate or consistent with the protection of investors, the Commission proposes to increase the offering limits (the amount that can be raised by an issuer per offering) for Rule 504 and Reg. CF beyond what Congress has dictated in the statute as the maximum permissible amount. Specifically, despite the fact that the maximum offering amount statutorily allowed under Securities Act Section 3(b)(1) is \$5 million, and Rule 504 was adopted pursuant to the Commission's authority under 3(b)(1), the Commission is proposing to raise that limit to \$10 million. Similarly, despite the fact that the maximum offering amount statutorily allowed under Securities Act Section 4(a)(6) is \$1.07 million (\$1 million adjusted to reflect changes in the Consumer Price Index), the Commission is proposing to raise the maximum to \$5 million.

In both instances, the Commission proposes to use its general exemptive authority under Securities Act Section 28 to circumvent the statute and raise these offering limits. This is a highly questionable use of the Commission's Section 28 authority. First, the proposal does not "exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions" from the provisions of Rule 504 or Reg. CF; the proposal fundamentally changes the conditions of those rules in ways that are not consistent with the statute. Second, Section 28 limits the Commission's exemptive authority to exemptions that are "necessary or appropriate in the public interest" and "consistent with the protection of investors."⁹⁹ In other words, even if one accepts that raising the offering limits is an appropriate use of its Section 28 authority, as we do not, the Commission has an obligation to conduct a serious analysis of the justification for and likely effects of its proposed change. But the Commission provides no compelling evidence that its proposal is either "necessary or appropriate" or "consistent with the protection of investors," and it ignores extensive evidence that its actions would put investors at risk, as we discuss further below. As such, this is a clear misuse of its Section 28 authority and these proposals should be withdrawn.

2. Increasing offering limits comes with very little upside and considerable downside risk.

As the Commission itself seems to acknowledge at times in this release, the proposed changes to the offering limits for Reg. A, Reg. CF, and Rule 504 are unlikely to have more than a marginal impact on capital formation. At most, the likely effect will be to change the decisions issuers make about which exemption to rely on rather than to increase the total amount of capital

⁹⁹ Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996)

raised. Indeed, it appears that one of the Commission’s primary goals with these proposed changes is to shift capital raising from 506 offerings, which are mostly sold to accredited investors, to these other exemptions, in order to provide more “opportunities” for financially unsophisticated, non-accredited retail investors.

Because a variety of other factors impact issuers’ decisions regarding which exemption to use, the proposal to raise the offering limits for Reg. A, Reg. CF, and Rule 504 is unlikely to have a material impact on those decisions for the majority of issuers, who have more attractive options available to them. This likely explains, for example, why only two percent of the capital raised in Regulation D offerings of under \$5 million by companies other than pooled investment funds from 2009 through 2019 was offered under Rule 504 (and under Rule 505, prior to its repeal), while 98 percent of the capital raised was offered under Rule 506. Obviously, issuers strongly prefer Rule 506 offerings, even when they are eligible to rely on Rule 504, and raising the offering limit is unlikely to change that.

Where the Commission proposal may have an impact is among the least attractive of the private offerings, those that rely on exemptions that give them access to retail investors precisely because they are unlikely to be attractive to more sophisticated market participants. While these issuers may “benefit” from the ability to raise larger amounts of capital from financially unsophisticated non-accredited investors, that benefit comes at the cost of significantly heightened risks to those investors. Here again, the Commission is proposing these changes without any effort to understand what the likely impact on vulnerable investors would be. Rather, it appears to deliberately ignore evidence of problems in these markets, which are only likely to increase if offering limits are increased, to the detriment of retail investors. Because they offer little potential benefit and significant potential harm, these proposals should be withdrawn.

3. The vast majority of Reg. A, Reg. CF, and Rule 504 offerings don’t hit current limits.

One reason we are skeptical that the proposal to increase offering limits will have a material impact on capital formation is that the vast majority of offerings under these exemptions don’t hit the current limits. For example, the Commission’s 2020 Regulation A Review estimates that only approximately 10 percent of issuers in Tier 2 offerings have reached the \$50 million offering limit across completed and ongoing offerings.¹⁰⁰ According to the 2019 Crowdfunding Report, only an estimated 29 offerings (or just over 2%) out of the 1,351 crowdfunding offerings that were initiated between May 2016 and December 31, 2018 reported raising at least \$1.07 million.¹⁰¹ In fact, the majority of crowdfunding issuers raised significantly less than either the existing offering limit or the maximum amount specified in their offering statements.¹⁰² The average offering raised in completed offerings was approximately \$208,400 and the median was even lower, at \$107,367.¹⁰³

¹⁰⁰ SEC Staff, Report to the Commission Regulation A Lookback Study and Offering Limit Review Analysis, March 4, 2020, <https://bit.ly/3dyduxK>.

¹⁰¹ See SEC Staff, Report to the Commission: Regulation Crowdfunding, June 18, 2019, <https://bit.ly/2XoD9TO>.

¹⁰² *Id.*

¹⁰³ *Id.*

And, even after the Commission raised the offering limit for Rule 504 offerings from \$1 million to \$5 million in 2016, the Commission found that the number of new offerings and the capital reported raised has remained flat or declined. “This data suggests that the higher threshold limits have not encouraged more issuers to conduct new offerings under the Rule 504 exemption, although those using the exemption are able to raise more capital in each offering and in the aggregate,” the Commission stated.¹⁰⁴ With no evidence to support its claim, the Commission nonetheless posits that, “Given the limited number of issuers that have used amended Rule 504 to raise capital ... it may be appropriate to revisit the Commission’s decision in 2016 not to raise the offering limit to \$10 million, as several commenters suggested at that time.”¹⁰⁵ If higher threshold limits have not encouraged more issuers to conduct new offerings under the Rule 504 exemption in the past, and instead the total capital raised in reliance on Rule 504 remained flat or decreased, then why would raising the offering limit again have any different effect? As we noted above, the fact that the large majority of Reg. D issuers who would qualify to use Rule 504 choose instead to rely on Rule 506 suggests that raising the offering limit is unlikely to have any impact on those decisions. The Commission offers no explanation to counter this reasonable assumption.

Despite clear evidence that there is no need to raise the current offering limits for these exemptions and no likely meaningful benefit from doing so, the Commission nonetheless proposes to increase the offering limit under Tier 2 of Reg. A from \$50 million to \$75 million, to increase the offering limit for crowdfunding from \$1.07 million to \$5 million, and to increase the offering limit under Rule 504 from \$5 million to \$10 million.

The proposed increase in the Reg. A offering limit is particularly questionable, since evidence suggests that those Reg. A offerings that currently reach the offering limit are concentrated in one area of the market. Buried in a footnote, the Commission states that, among the small minority of Reg. A issuers who reached the Tier 2 offering limit, almost all were real estate issuers. So it is reasonable to conclude that real estate issuers would disproportionately benefit from an increase in the offering limit. Given that fact, one would reasonably expect the Commission to try to determine what the impact its changes would have on issuers of and investors in such offerings. Would that benefit or harm investors? Disturbingly, the Commission doesn’t even attempt to answer these questions.

4. Increasing the offering limits for Reg. A, Reg. CF, and Rule 504 is unlikely to materially change how capital is raised in private markets. The lion’s share of capital will continue to be raised pursuant to Rule 506.

It appears that one of the Commission’s primary goals with these proposed changes is to prompt issuers who currently conduct Rule 506 offerings, which are mostly sold to accredited investors, to use these exemptions instead in order to provide more “opportunities” for financially unsophisticated, non-accredited retail investors to invest in private offerings.¹⁰⁶ For

¹⁰⁴ Release at 124.

¹⁰⁵ *Id.*

¹⁰⁶ Chairman Jay Clayton, Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework, March 4, 2020, <https://bit.ly/2U4lzCu> (stating that he was trying to “expand access to private investments for Main Street investors.”).

the reasons discussed above, attempting to shift these offerings is unlikely to have more than a marginal impact in this regard, and, as we discuss further below, any impact it does have is likely to be harmful to retail investors.

Despite the Commission’s attempt to promote the use of Reg. A, Reg. CF, and Rule 504, the fact is that issuers seeking to conduct an exempt offering overwhelmingly prefer to use Rule 506. For example, the Commission estimated that out of approximately \$2.9 trillion of new capital that was raised through exempt offering channels in 2018, \$1.5 trillion was raised under Rule 506(b) and \$211 billion was raised under Rule 506(c).¹⁰⁷ Thus, 58% of new capital raised through exempt offerings was raised pursuant to Rule 506. In contrast, a combined total of less than \$3 billion (0.1 percent) was raised through Regulation A (\$736 million), Regulation Crowdfunding (\$55 million), and Rule 504 (\$2 billion) offerings.¹⁰⁸ These exemptions represent a drop in the bucket of total capital raised. The amount of new capital raised in 2018 does not appear to be an anomaly. Rather, the number of issuers, the number of offerings, and amount raised pursuant to Rule 506 have been orders of magnitude larger than Reg. A, crowdfunding, and 504 for years.¹⁰⁹

Moreover, Rule 506 is the preferred exemption even among issuers who are seeking to raise amounts of capital that fall within the offering limits for these other exemptions. For example, from May 16, 2016 through December 31, 2018, approximately 1,351 offerings were initiated under Regulation Crowdfunding and 519 were completed. These offerings raised \$108 million for issuers. In contrast, over the same period approximately 12,700 issuers relied on Regulation D to conduct offerings of up to \$1.07 million (the 12-month limit under Regulation Crowdfunding), totaling approximately \$4.5 billion.¹¹⁰ This suggests the market is deciding which exemptions best serve their needs and that any restrictions posed by limiting Rule 506 offerings to accredited investors are more than outweighed by other perceived benefits of the exemption.

The Commission appears to acknowledge that there are many plausible reasons, other than the offering limits, to explain the lack of demand for Reg. A, Reg. CF, and Rule 504 exemptions relative to Rule 506. For example, the 2020 Regulation A Review acknowledges that modest financing levels in the Reg. A market “are likely related to a combination of factors, including the pool of issuers and investors drawn to the market under existing conditions; the availability to issuers of attractive private placement alternatives without an offering limit; the availability to investors of attractive investment alternatives outside of Regulation A with a more diversified pool of issuers; limited intermediary participation and a lack of traditional

¹⁰⁷ Release at 115.

¹⁰⁸ *Id.* See Table 2 of the Concept Release.

¹⁰⁹ While we were unable to locate standard measures of comparison, it is clearly the case that Rule 506 is the preferred exemption by orders of magnitude. For example, between September 2013 and December 2018, 97,164 issuers engaged in 112,193 506(b) offerings. During that same time, 8,025 issuers engaged in 9,358 506(c) offerings. In contrast, between June 2015 and December 2019, 183 issuers engaged in 487 Reg. A offerings (382 offerings qualified by the Commission). Similarly, between May 16, 2016 and December 31, 2018, over 1200 issuers engaged in roughly 1,350 crowdfunding offerings. Likewise, there were between 400 and 600 new Rule 504 offerings every year from 2013 to 2018 (The aggregate number of 504 and 505 offerings has held steady or declined).

¹¹⁰ Release at 126, citing the 2019 Crowdfunding Report and the Concept Release.

underwriting; and a lack of secondary market liquidity.”¹¹¹ Instead of following this reasoning to its logical conclusion -- that market forces unlikely to be influenced by raising the offering limits are driving issuer decisions -- the Commission arbitrarily concludes that the offering limits should be increased. If only the Commission allows more supply into the market, the Commission posits, that will create issuer and investor demand.

The fact that the vast majority of issuers are not raising the legal maximum under these exemptions, and are instead choosing to raise similar amounts using alternative exemptions, pretty clearly shows that the offering limits are not a substantial factor in their decisions. Accordingly, Econ 101 tells us that increasing the amount issuers can raise pursuant to these exemptions is unlikely to have a material impact on the use of these exemptions.

5. To the extent the proposed changes do increase use of the Reg. A, Reg. CF, and Rule 504 exemptions, the impact could be devastating for unsophisticated non-accredited retail investors.

Given issuers’ clear, long-standing preference for using Rule 506 to conduct exempt offerings, it seems all but certain that issuers who are able to raise capital through Rule 506 will continue to do so. Certainly, the Commission has failed to present any evidence that would contradict that assumption. One side effect of this preference is that such offerings will be largely limited to accredited investors, who in theory if not in fact, are better able than the average retail investor to fend for themselves without the protections afforded in the public markets.¹¹² To the extent an issuer is unable to raise capital using Rule 506, because its offering is unattractive to accredited investors, it can tap a broader pool of investors by relying on Regulation A, Regulation Crowdfunding, or Rule 504, where non-accredited investors are free to participate. This is likely to result in adverse selection, whereby the better deals are sold to accredited investors in reliance on Rule 506 while the worse deals are sold to members of the general public subject to Reg. A, Reg. CF, and Rule 504.

The Commission doesn’t dispute the possibility that adverse selection may be an issue and may increase as a result of the proposed changes. However, the Commission posits that, “even if adverse selection increased somewhat in some segments of the exempt market under the proposed amendments, the investor protections applicable to each exemption would remain as significant safeguards against the risk of losses for less sophisticated investors.”¹¹³ The Commission further states that increasing the offering limits for these exemptions would benefit non-accredited investors because “[e]xpanded access to exempt securities could enable non-accredited investors to allocate capital across a broader range of opportunities.”¹¹⁴ However, the Commission makes no effort to support these statements. If it undertook an even minimally serious effort to determine whether this is true in practice, it would be forced to acknowledge that its belief is deeply misguided. Not all “opportunities” are beneficial, and the existing rules don’t sufficiently protect less sophisticated non-accredited investors from the risk of loss.

¹¹¹ Release at 119.

¹¹² Rule 506(b) limits the number of non-accredited investors that can participate in 506 offerings to 35, provided that those investors are sophisticated. Rule 506(c) does not allow non-accredited investors to participate in 506(c) offerings.

¹¹³ Release at 168.

¹¹⁴ *Id.* at 169.

As we discussed at length in our comment on the Concept Release, the available data about the Reg. A and crowdfunding markets, while limited, raises serious red flags.¹¹⁵ The Commission appears to be deliberately ignoring that evidence, including evidence we provided in our earlier comment letter that the crowdfunding market has been characterized by a culture of noncompliance and that the expansion of Reg. A has been an unmitigated disaster for investors. As noted above, the *Wall Street Journal* has described the Reg. A+ market as “tainted by poor post-IPO performance and concerns about fraud,”¹¹⁶ and Renaissance Capital has referred to the Reg. A+ market as “the wild west of IPOs.”¹¹⁷ Examples of suspect filings, deceptive marketing, and boiler room tactics abound, as we detailed in our earlier letter and as the Commission has chosen to ignore.¹¹⁸ The Commission has an obligation to engage with that evidence and explain how it has nonetheless concluded that the investor protections provided by Reg. A are adequate before moving forward with its current proposal.

Similarly, we presented evidence in our previous letter that, far from presenting attractive options for non-accredited investors, “most Reg. A+ businesses haven’t gotten beyond the startup phase known as the pipedream,” as a 2018 *Barron’s* article described it.¹¹⁹ Examples cited in the article include businesses seeking capital for cannabis paraphernalia, flying cars, and to study UFOs, telepathy, and light-speed travel. In other words, if you are looking for where COVID-related investment scams are likely to emerge, the Reg. A market would be a good place to start your search. And, while Regulation A’s supporters have touted Regulation A’s job creating potential, the *Barron’s* article found 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.”¹²⁰ 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%.¹²¹ Similarly, the *Barron’s* article described the “woeful performance” of the few dozen companies that were currently exchange-listed as well as the difficulty of trading or getting a price quote for the vast majority of companies that

¹¹⁵ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

¹¹⁶ Alexander Osipovich, Exchanges Shy Away From Mini-IPOs After Fraud Concerns, *Wall Street Journal*, June 10, 2019, <https://on.wsj.com/2lrPWET>.

¹¹⁷ 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.).

¹¹⁸ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

¹¹⁹ Bill Alpert, Brett Arends, and Ben Walsh, Most Mini-IPOs Fail the Market Test, *BARRON’S*, February 13, 2018, <http://bit.ly/2FwKPw5>.

¹²⁰ *Id.*

¹²¹ 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%).

aren't exchange listed.¹²² 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.¹²³

As discussed above, Reg. A+ has been characterized as “the wild west of IPOs.”¹²⁴ The results have been harmful for both investors and legitimate issuers. The major exchanges have learned from this experience, even if the Commission has not. 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.¹²⁵ Before moving forward with its plans to further raise the offering limit for Reg. A offerings, the Commission has an obligation to consider and respond to evidence that the move is not needed, would be harmful to investors, and would not promote sustainable capital formation and job creation. It has entirely failed to do so in this release.

Similarly, before it moves forward with its proposal to raise the offering limit for crowdfunding beyond the limit set in statute, the Commission has an obligation to carefully consider, as it has failed to do here, what the impact would be on vulnerable retail investors. And, here again, there is significant cause for concern that goes entirely unaddressed in the proposing release.

As we noted above, Professor Bullard conducted research on a large sample of crowdfunding offerings and documented widespread non-compliance by both issuers and portals with the most basic regulatory requirements under Reg. CF.¹²⁶ This included violations of the very reporting requirements the Commission points to as adequately protecting investors in crowdfunding offerings. Bullard noted, moreover, that he set a very low bar for determining “compliance.” Filers that filed four financial statements for each applicable fiscal year that were, as appropriate, either certified by the CEO or reviewed by an accountant were judged compliant with the financial statement filing requirement. “If the financial statements were subject to a more demanding, substantive compliance standard, a much smaller fraction would be deemed to have been compliant,” he wrote.¹²⁷ Similarly, filers “needed only to file a document that would be facially acceptable as an annual report” to be deemed compliant with the annual reporting requirement. Here again, he wrote, “if these filings were subject to any level of substantive review, only a tiny fraction would likely be found to be in compliance with Reg. CF.” Bullard went on to note that, “Although Filers are the primary violators, responsibility lies primarily with

¹²² Bill Alpert, Brett Arends, and Ben Walsh, Most Mini-IPOs Fail the Market Test, BARRON'S, February 13, 2018, <http://bit.ly/2FwKPw5>.

¹²³ 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>.

¹²⁴ Renaissance Capital, Reg. A+ is the wild west of IPOs and here's the latest example, July 10, 2019, <http://bit.ly/2m4WyJr>.

¹²⁵ See Alexander Osipovich, Exchanges Shy Away From Mini-IPOs After Fraud Concerns, Wall Street Journal, June 10, 2019, <https://on.wsj.com/2lrPWET>.

¹²⁶ Mercer Bullard, Crowdfunding's Culture of Noncompliance: An Empirical Analysis, 24 Lewis & Clark L. Rev. (forthcoming 2020), <http://bit.ly/2l8Upfv>.

¹²⁷ *Id.*

intermediaries and regulators. The dismal level of compliance reflects an abdication of oversight responsibility by intermediaries.”¹²⁸

While Bullard’s research provides the broadest available analysis of compliance in the crowdfunding market, he is not alone in identifying significant compliance problems. 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.¹²⁹ As Sara Hanks of CrowdCheck explained, uFundingportal demonstrated “an almost complete failure to follow disclosure and filing requirements.”¹³⁰ More recently, FINRA shut down DreamFunded Marketplace, after a hearing panel ruled that DreamFunded and its CEO “committed multiple violations” of both the SEC’s Regulation Crowdfunding Rules and FINRA’s Funding Portal Rules.¹³¹ Despite this evidence of significant problems, the Commission has been largely silent on the topic. In contrast to Bullard’s careful empirical analysis, for example, the Commission’s own crowdfunding report is, in Bullard’s words, “strangely devoid of actual data or other information on whether issuers or intermediaries are actually complying with the law.”¹³² The same is true of the “analysis” supporting this proposal.

As we stated in our comment on the Concept Release, before proposing any changes to crowdfunding regulation designed to further expand this market or encourage greater investor participation, the Commission had a responsibility to examine non-compliance in crowdfunding markets and remedy those deficiencies. It is not enough to simply posit, as the Commission does here, that “raising the offering limit would be consistent with investor protection because existing Regulation Crowdfunding requirements, including the intermediary requirements and the eligibility, disclosure, and ongoing reporting requirements for issuers would continue to provide appropriate investor protections at this higher offering limit.”¹³³ If, as Professor Bullard’s research documents, a large majority of crowdfunders are not complying with those basic requirements, the Commission cannot reasonably rely on the existence of those regulatory requirements as providing an adequate safeguard for investors. At the very least, it has an obligation to engage with the research (not bury it in a footnote) and explain on what basis it has reached a different conclusion about the adequacy of investor protections. To move forward without first conducting that analysis would, like the Commission’s failure to impose sanctions for noncompliance with the Form D filing requirement, 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” documented in Bullard’s research and increase the risk to investors.

¹²⁸ *Id.*

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

¹³⁰ JD Alois, FINRA Action on uFundingportal: Potential for Fraud Found on Crowdfunding Platform, Crowdfund Insider, December 13, 2016, <http://bit.ly/2mI4d0i>.

¹³¹ Department of Enforcement v. Dreamfunded, FINRA Office of Hearing Officers, Extended Hearing Panel Decision, No. 2017053428201 (June 5, 2019), <http://bit.ly/2I81qwX>.

¹³² Mercer Bullard, Crowdfunding’s Culture of Noncompliance: An Empirical Analysis, 24 Lewis & Clark L. Rev. ____ (forthcoming 2020), <http://bit.ly/2I8Upfv>.

¹³³ Release at 132.

In short, if the Commission moves forward with its proposal to raise the offering limits for Reg. A, Reg. CF, and Rule 504, vulnerable retail investors are likely to pay the price in the form of increased investment losses. The Commission itself acknowledges this possibility, stating, “The proposed amendments to raise Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 offering limits might increase aggregate potential investor losses in those offerings.”¹³⁴ But, in keeping with its single-minded focus on satisfying issuer demands, the release dismisses this prospect with an indifferent shrug.

6. To the extent increasing the limits allows issuers to raise more capital through private markets than they otherwise would, it could decrease these issuers’ need to go public, further expanding private markets at public markets’ expense.

As discussed above, for a number of reasons, we think it is unlikely that raising the limits on these exemptions will have more than a marginal impact on how capital is raised. But to the extent that raising the offering limits *does* cause issuers to raise more capital through exempt offerings, as appears to be the Commission’s goal, it could decrease issuers’ need or incentive to tap public markets through registered offerings. This risk is more pronounced given the fact that other aspects of the proposal allow issuers to mix and match their use of different exemptions in close proximity in time without having to worry about those offerings being integrated and allow issuers to engage in general solicitation, in the form of test-the-waters communications, across all exempt offerings. To the extent that increasing the offering limits for these exemptions increases the ability to sell to non-accredited investors, increasing the pool of potential investors, that has the potential to reduce the need to go public even further.

In short, if the Commission succeeds in its goal of increasing use of exempt offerings, that is likely to have a damaging impact on the health and vitality of our public markets, which have been widely acknowledged to be “the gold standard” for both investor protection and capital formation.¹³⁵ By allowing and implicitly encouraging more money to be raised in private markets, the Commission would be depriving investors and the market of all the benefits associated with a registered offering. And yet, the Commission has failed even to consider what impact this would have on either investors or the health of our public markets. It cannot reasonably move forward without conducting that analysis.

¹³⁴ Release at 235.

¹³⁵ See Letter from Erik F. Gerding, et. al., to the SEC, September 24, 2019, <http://bit.ly/2ombQKO> (“Public markets represent the gold standard for investor protection and capital formation,” including by providing mandatory disclosure, remedies, and oversight, while private markets in contrast, have information asymmetry, liquidity risk, dilution risk, and lack of recourse); See also Letter from Tyler Gellasch, Association, to the SEC, September 30, 2019 <https://bit.ly/3dusegT> (“The regulatory regime provided by the registration and ongoing reporting obligations of the Securities Act and the Exchange Act performs essentially two critical, but distinct functions: 1. It ensures that key information about securities, including issuer governance, operations, and financials are widely available, so that market participants can accurately assess the value of the securities and allocate capital efficiently; and 2. It levels the playing field between investors and issuers, as well as between different types of investors, by ensuring that all investors -- not just those with market power or access -- have access to key information in a timely manner.”).

7. The Commission has proposed these changes to the offering limits for Reg. A, Reg. CF, and Rule 504 offerings without engaging in a minimally serious effort to understand what the likely impact would be.

It's clear from the release that the Commission has no idea what the impacts of raising the offering limits would be. One would expect that, before engaging in a major rewrite of our securities regulations, the Commission would attempt to find answers to that question by doing serious, robust economic analysis of these markets where the data does exist and by requiring enhanced data to be collected where it is not currently available. As discussed above, the Commission has studiously ignored evidence that conflicts with its rosy outlook of its proposal's supposedly beneficial effects. In addition, instead of conducting the necessary analysis, the Commission simply outlines the range of potential effects that "might" occur without providing any factual data to support a conclusion about which outcome -- from extremely positive to extremely negative -- is most likely.¹³⁶ Here are just a few representative examples:

- "Expanding the offering limits as proposed thus *might* attract additional issuers to these exemptions."¹³⁷
- "It is difficult to predict how many new issuers would be drawn to Regulation Crowdfunding, Regulation A, and Rule 504 under the proposed offering limits."¹³⁸
- "We lack data or a methodology that would allow us to predict how many new issuers that would not have otherwise undertaken any securities offering would be drawn to Regulation Crowdfunding, Regulation A, and Rule 504 under the proposed offering limits."¹³⁹
- "The proposed amendments...*might* increase the potential for capital formation in those markets by enabling existing issuers that are approaching offering limits to raise larger amounts of financing, as well as by drawing new issuers that may be deterred by relatively low offering limits today. The benefits under the proposed approach are expected to be partly attenuated to the extent that some issuers drawn to the amended exemptions *might* be switching from other securities offering methods; however, such issuers *might* still be able to optimize their financing strategy and lower their cost of capital."¹⁴⁰
- "Amendments that increase the offering limits of Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 also *might* improve the composition of the pool of issuers relying on these exemptions....A broader and more diversified range of investment opportunities *might* benefit investors in these market segments, particularly non-accredited investors that seek exposure to private companies but are constrained from participation in private placements."¹⁴¹
- The proposed amendments to raise Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 offering limits *might* increase aggregate potential investor losses in those

¹³⁶ The word "might" appears a total of 238 times in the release.

¹³⁷ Release at 231 (emphasis added).

¹³⁸ *Id.*

¹³⁹ *Id.* at 233.

¹⁴⁰ *Id.* at 234 (emphasis added).

¹⁴¹ *Id.* (emphasis added)

offerings. Amendments that increase the offering limits of Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 *could* make the exemptions more attractive to issuers that are unable to meet more restrictive requirements applicable to larger offerings today, resulting in higher-risk issuers potentially being overrepresented among the issuers relying on the amended exemptions.”¹⁴²

- “[T]he higher offering limits for the three discussed exemptions, combined with the proposed amendments expanding the integration safe harbors, *might* allow a broader range of issuers to raise capital from non-accredited investors to meet their financing needs without registration. As a result some of these non-accredited investors *might* receive less disclosure and face lower liquidity of their holdings.”¹⁴³
- “[T]hese amendments *might* enable some issuers to delay or forgo a registered offering, thereby avoiding the associated costs of Exchange Act registration and being a public reporting company.”¹⁴⁴
- “The resulting composition of the issuers that would rely on these exemptions remains unclear. One possibility is...The higher offering limits also *might*...Another possibility is...We lack the data, or a methodological approach, to disentangle these competing effects.”¹⁴⁵

The Commission appears undaunted by the lack of “data or a methodological approach” to support its proposed changes. Instead, it appears content to rely on its unsupported suppositions, and industry advocacy, as if they were gospel. For example, in justifying increasing the Reg. A offering limit, the Commission highlights how “[e]vidence from public commentary since the 2015 amendments indicates that a higher offering limit may help attract a larger and potentially more seasoned pool of issuers and intermediaries or institutional investors to the Regulation A market.”¹⁴⁶ As has become standard practice, the Commission buries the truth in a footnote, admitting that “the staff lacks data that would allow it to assess how a specific offering limit increase would affect the size and composition of the pool of prospective issuers, intermediaries, and investors in the Regulation A market.”¹⁴⁷

Similarly, in justifying increasing the crowdfunding offering limit, the Commission acknowledges the degree to which its proposal is driven by industry lobbying, even when there is no data to support industry claims. The release states, “Despite few issuers meeting the offering limit, we have received feedback from market participants and observers supporting a higher offering limit and note that the offering limit may not reflect current capital raising trends. In addition, some intermediaries suggested that, while few offerings reach the current limit, many issuers choose not to utilize the crowdfunding exemption because the limit is too low.”¹⁴⁸ Meanwhile, concerns from academics and investor advocates, not to mention the state securities

¹⁴² *Id.* at 235 (emphasis added).

¹⁴³ *Id.* at 236 (emphasis added).

¹⁴⁴ *Id.* (emphasis added)

¹⁴⁵ *Id.* at 168 (emphasis added).

¹⁴⁶ *Id.* at 119-120.

¹⁴⁷ *Id.* at 120, note 248.

¹⁴⁸ *Id.* at 127.

regulators who play the primary role in policing these markets, are relegated to the footnotes and ignored in the policy proposals.

8. The Commission proposes to increase investment limits for investors in crowdfunded offerings, increasing the risk that vulnerable retail investors lose more of their hard-earned savings.

The primary protection for investors in the crowdfunding market is the tight limit the statute places on the amount that investors can invest in crowdfunding offerings in a 12-month period. The proposal would dramatically increase the investment limits for investors in crowdfunded offerings, and reduce investor protections, in two ways. First, it would eliminate the crowdfunding investment limit for accredited investors. Second, it would increase the investment limit for non-accredited investors by basing the percentage on the “greater of” their annual income or net worth, rather than the existing “lesser of” standard. Neither change is warranted, and both would put retail investors at undue risk.

In justifying the elimination of investment limits for accredited investors, the Commission posits that “these individuals satisfy certain criteria that suggest they are capable of protecting themselves in transactions that are exempt from registration under the Securities Act.”¹⁴⁹ While the accredited investor is *supposed* to identify investors who can fend for themselves, there is no evidence that the existing definition, which relies on financial thresholds, is successful in identifying a pool of investors that: 1) have access to the same kind of information that would be available in a public offering, 2) are sufficiently financially sophisticated to evaluate the potential risks and rewards of the investment to determine whether it is appropriate for them, or 3) can withstand the heightened risks, including liquidity risks and risk of loss, typically associated with private securities. On the contrary, what evidence exists supports the opposite conclusion. Meanwhile, the Commission has steadfastly refused to conduct the analysis that would enable it to reach a conclusion, one way or another, about accredited investors’ ability to fend for themselves. Among other things, it has refused to consider the impact that inflation has had and continues to have on a definition that relies on financial thresholds that were set in 1982 and have not been indexed to inflation, even as it forges ahead with an unjustified and unsupported proposal to further expand the population of accredited investors.¹⁵⁰

As we have discussed elsewhere, many accredited investors qualify as accredited investors based on a lifetime of retirement savings. As they look to make those savings last

¹⁴⁹ *Id.* at 133.

¹⁵⁰ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, March 9, 2020, <https://bit.ly/33PMyoP>. The Commission itself recognizes that the interplay between the accredited investor proposal and this proposal would result in a larger pool of accredited investors to sell unlimited exempt offerings to. It states, “In a recent release, the Commission has proposed to amend and expand the accredited investor definition. If adopted, those amendments would affect the economic impacts of the amendments proposed here. In particular, some of the effects of the changes to the exempt offerings proposed here that are intended to facilitate exempt offering financing under Regulation D (e.g., expanded integration provisions) or under other exemptions (e.g., exempting accredited investors from the investment limits under Regulation Crowdfunding) might have relatively greater economic effects if issuers can offer securities to an expanded pool of accredited investors as contemplated by the proposed accredited investor definition amendments.” Release at 176.

throughout several decades of retirement, they can ill-afford to put their hard-earned money at risk in illiquid, opaque and speculative private market investments. There is simply no justification for stripping them of the minimal protections that exist in the crowdfunding market to protect them from the risk of suffering unaffordable losses.

The proposal to increase crowdfunding investment limits for non-accredited investors is even less justifiable, exposing millions of middle income Americans who struggle to fund a dignified and independent retirement to potentially devastating losses. It would do this by revising the calculation for determining investment limits, basing those limits on the greater, rather than lesser, of net worth or income. When the crowdfunding rules were adopted just a few years ago, the Commission considered this question and decided to use the “lesser of” standard, as the SEC’s Investor Advisory Committee recommended at the time, due to concerns about the number of households where there is a sizable gap between net worth and annual income, and the questionable ability of these households to withstand the risk of loss. As the IAC stated in its recommendation, “The Committee believes that this “greater of” approach ... is inconsistent with the intent of the provision to minimize the risk that investors will suffer unaffordable losses.”¹⁵¹ It went on to note that the percent limits in the statute “are already quite high” and that “few financial professionals would recommend that even their wealthiest clients put anything close to ten percent of their net worth in the individual stocks of early stage start-up companies. This concentration issue would be even more of a concern for the moderate income individuals who will be permitted to participate in crowdfunding.”¹⁵² In deciding to adopt the “lesser of” standard in the final rule, the Commission agreed that, given the concerns expressed about “investors potentially incurring unaffordable losses under the proposed rule,” it determined that it was important to try to “limit investment losses in crowdfunding offerings for investors who may be less able to bear the risk of loss.”¹⁵³

The Commission fails to provide any evidence in this proposal to support its reversal of the crowdfunding rule’s central investor protection. Here again, it ignores evidence that should call into question expanding crowdfunding in any way until the culture of non-compliance is addressed. Instead, in attempting to justify its unjustifiable action, the Commission cites its “experience with Regulation Crowdfunding,”¹⁵⁴ which clearly doesn’t include assessing the level of compliance, and “concerns of commenters that the existing investment limits may be hampering the utility of the exemption.”¹⁵⁵ Given the array of available exemptions, the Commission provides no evidence that issuers are harmed by any lack of “utility” in the crowdfunding exemption.

The Commission also claims to see investor benefits in its proposal. It states, “By permitting investors to use the greater of the income or net worth threshold, investors would have more flexibility in making their investment decisions.” But it fails to provide any evidence that

¹⁵¹ Recommendation of the Investor Advisory Committee: Crowdfunding Regulations (April 10, 2014), <https://bit.ly/36Stc4d>.

¹⁵² *Id.*

¹⁵³ Final Rule, Crowdfunding, Release Nos. 33-9974; 34-76324; File No. S7-09-13, October 30, 2015, <https://bit.ly/2yWQ4mx>.

¹⁵⁴ Release at 134.

¹⁵⁵ *Id.*

investors want or would benefit from that greater “flexibility.”¹⁵⁶ The IAC rebutted this questionable assertion in its recommendation, stating: “While some assert that maximizing the permissible investment amounts could increase the ability of investors to diversify across multiple crowdfunding offerings, the Committee believes, based on what is currently expected in the crowdfunding space, that the risks of overinvesting in the general category of companies that use crowdfunding far outweigh the benefits of increased potential for diversification within this category. Furthermore, increasing the investment limits without also limiting the amounts that can be put into any one individual company will not necessarily result in greater diversification across multiple offerings; it could just as easily result in investors’ making a bigger bet on a single offering. Indeed, the latter may be more likely to occur, since investing in a single offering is simpler than researching and investing in a multitude of offerings.”¹⁵⁷ These concerns, like all similar concerns from investor advocates, are ignored in the proposal.

Here again, the Commission acknowledges it has no idea what’s going on in this market or how the proposed changes would affect the market and investors. Instead of analyzing the best available data to develop reasonable assumptions about the likely impact, it once again simply lists a range of outcomes that “might” occur. Here are a few typical examples:

- “We lack the data to assess how many investors may be affected by the proposed amendments to Regulation Crowdfunding investment limits, in part because investor information generally is not available and is not required to be disclosed in the course of an offering or upon completion of an offering.”¹⁵⁸
- “On the one hand, raising investment limits *might* allow some investors, particularly accredited investors and more sophisticated non-accredited investors, that were previously constrained by existing investment limits to attain a more efficient portfolio allocation. On the other hand, for some less sophisticated investors, relaxing investment limits *might* enable an inefficiently high exposure to crowdfunding investments resulting in overall under-diversification in their portfolios.”¹⁵⁹
- “Depending on how the additional investor capital drawn to Regulation Crowdfunding compares to the amount of additional financing sought by issuers in these markets after the amendments, the amendments *might* affect competition among issuers for investor capital.”¹⁶⁰

The lack of data reflected here is a self-imposed problem. The Commission has failed to conduct a serious inquiry in the crowdfunding market. It has no idea, for example, how risky these investments are or how they perform. Do crowdfunding issuers use the money effectively to grow and prosper? Or do they squander the money that they take from investors, going out of business soon after taking investors’ money? Are the businesses typically appropriately valued or mis-valued? What is the likelihood that the terms of agreements limit investor rights or allow for dilution of crowdfunding investment interests, effectively ensuring that crowdfunding investors

¹⁵⁶ *Id.*

¹⁵⁷ Recommendation of the Investor Advisory Committee: Crowdfunding Regulations (April 10, 2014), <https://bit.ly/36Stc4d>.

¹⁵⁸ Release at 247.

¹⁵⁹ Release at 249 (emphasis added).

¹⁶⁰ Release at 250 (emphasis added).

never participate in company profits, if any, or lose all or most of their investment, even if the company is successful? The Commission has apparently made no effort to find out the answers to these most basic of questions before forging ahead with its proposal.

It would be bad enough if the Commission were merely acting without conducting an adequate analysis. In fact, however, the Commission appears to be deliberately ignoring evidence that conflicts with its preferred deregulatory approach. Otherwise, since the Commission is clearly aware of Professor Bullard's research documenting widespread noncompliance with the most basic regulatory requirements in Reg. CF, how could it justify the statement that "we are not aware of evidence since Regulation Crowdfunding's adoption to indicate this market requires a more stringent approach to investment limits than other exemptive regimes"?¹⁶¹ After all, the crowdfunding requirements are designed to protect investors, particularly vulnerable retail investors. If crowdfunding issuers don't comply with existing requirements, those protections are not being afforded to these investors. Given this evidence of noncompliance with investor protection regulations, does the Commission intend to imply with this statement that it simply expects non-compliance as the norm in exempt offerings, that it is indifferent to the investor harm that may result from that non-compliance, or both?

F. Prohibiting crowdfunding securities with contingent features is the only pro-investor aspect of the proposal and even that prohibition doesn't go far enough.

The only aspect of the proposal that would strengthen protections for investors rather than weaken them is the provision to limit the types of securities that may be offered and sold in reliance on Regulation Crowdfunding. Currently, Reg. CF includes no such restrictions. As a result, issuers using Regulation Crowdfunding have offered and sold a number of non-traditional securities with complex, contingent features. These include Simple Agreements for Future Equity ("SAFEs"), "crowd notes," and revenue participation interests. According to Professor Bullard, "These three types of securities share the disadvantages that they are nonvoting and lack the information rights that are typical for common shareholders. Their holders have no right to know, for example, if the contingency that triggers their right to receive equity has occurred."¹⁶²

About one-quarter of crowdfunding filers have offered SAFEs.¹⁶³ A SAFE provides investors with a future equity stake in the issuer *if* certain triggering events, controlled by the terms of the agreement, occur. Typically, a triggering event occurs when the issuer subsequently raises capital in a preferred stock offering. There is no guarantee that the SAFE's triggering event will occur, and there is a significant likelihood in the crowdfunding context that it won't occur. Until a triggering event occurs, SAFE holders have no status as equity owners, and any shares they ultimately receive have no voting rights.

Given these features, the name SAFE is misleading. According to former Commissioner Michael Piwowar, "despite its name, a so-called SAFE is neither 'simple' nor 'safe.'"¹⁶⁴ As

¹⁶¹ Release at 134-135.

¹⁶² Mercer Bullard, *Crowdfunding's Culture of Noncompliance: An Empirical Analysis*, 24 *Lewis & Clark L. Rev.* (forthcoming 2020), <http://bit.ly/218Upfv>.

¹⁶³ *Id.*

¹⁶⁴ Commissioner Michael S. Piwowar, Opening Remarks at 2017 SEC/NASAA Annual Section 19(d) Conference, May 9, 2017, <https://bit.ly/2zNiaRI>.

noted above, SAFEs depend on the occurrence of a specific triggering event, according to the specific terms of the agreement. Determining whether that event has occurred may not be straightforward. In addition, the specific payout of a SAFE when a triggering event occurs may rely on a complex formula that also may not be straightforward. As a result, according to Professor Bullard, “unraveling the resulting obligations of an issuer are complex tasks, and issuer obligations may be difficult to enforce...”¹⁶⁵

SAFES are particularly poorly suited for the crowdfunding context. A recent SEC Investor Bulletin explained it well: “SAFES were designed for a specific type of startup. SAFES were developed in Silicon Valley as a way for venture capital investors to quickly invest in a hot startup without burdening the startup with the more labored negotiations an equity offering may entail. Oftentimes, for the venture capital investor, it was more important to get the investment opportunity, and possible future opportunities, with the startup than it was to protect the relatively small investment represented by the SAFE. In addition, the various mechanisms of the SAFE, from the triggering events to the conversion terms, were designed to best operate in the context of a fast growing startup likely to need and attract additional capital from sophisticated venture capital investors.”¹⁶⁶ According to Professors John Coyle and Joseph Green, VC SAFES are “predicated on the expectation that the issuer will eventually raise a round of institutional VC and otherwise follow the traditional path of a high-tech venture-backed startup.”¹⁶⁷ In contrast, “[i]n the crowdfunding context, . . . the vast majority of companies raising money are unlikely to ever raise institutional venture capital” and accordingly are not likely to trigger the issuance of future equity to SAFE holders. They conclude that, “[s]ince the SAFE was developed as a means of investing in startups that expect to raise such funding at a later date, it is not the right tool for channeling retail investment capital to crowdfunding companies.”¹⁶⁸

Professors Coyle and Green also argue that retail investors are unlikely to understand these key differences in purpose and use between SAFES in the VC context and SAFES in the crowdfunding context. “[I]nexperienced retail investors may mistakenly believe that they are receiving . . . a security that they believe all of the top startups and investors in Silicon Valley use,” according to the professors.¹⁶⁹ As a result, they conclude, “SAFES are not well suited to being used in crowdfunding transactions.”¹⁷⁰

As the Commission rightly notes in the release, the use of SAFES could pose particular challenges in the crowdfunding context given that “investors in Regulation Crowdfunding offerings may have less sophistication and resources to analyze novel security types with complex payoff structures that may pose significant valuation challenges.”¹⁷¹ Further, the use of SAFES in the crowdfunding context “could result in harm to investors who may face challenges

¹⁶⁵ Mercer Bullard, *Crowdfunding's Culture of Noncompliance: An Empirical Analysis*, 24 *Lewis & Clark L. Rev.* ___ (forthcoming 2020), <http://bit.ly/2l8Upfv>.

¹⁶⁶ SEC's Office of Investor Education and Advocacy, *Investor Bulletin: Be Cautious of SAFES in Crowdfunding*, May 9, 2017, <https://bit.ly/3crxSir>.

¹⁶⁷ Joseph Green and John Coyle, *Crowdfunding and the Not-So-Safe SAFE*, 102 *Virginia Law Review Online* 168-182 (December 2016), <https://bit.ly/3cqXVv8>.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ Release at 260.

in analyzing and valuing such securities, or who may be confused by the descriptions of such securities on the funding portals. These kinds of securities may also create confusion for retail investors who may not understand the differences between these securities and traditional common stock.”¹⁷² Finally, given the extremely high likelihood that SAFE triggering events do not occur, these investors are likely to be harmed when the vast majority of SAFE crowdfunding investments turn out to be completely worthless and these investors lose their entire investment.

While the proposed prohibition of SAFEs and other contingent agreements is a good first step, it would not fully address the problem that investors in crowdfunding [and Reg. A offerings] have when they are eligible to purchase certain classes of securities that have different, and typically investor-unfriendly, voting powers and valuation methods from other classes of securities. As the Commission acknowledged in the final crowdfunding rule release, crowdfunding investors are unlikely to have the experience or market power “to negotiate various anti-dilution provisions ... that have been developed by institutional and angel investors...”¹⁷³ While requiring disclosures on these features may benefit some investors, it is highly unlikely that the vast majority of crowdfunding investors are sufficiently financially sophisticated to make an informed decision with regard to these vitally important issues. We believe a more investor protective approach is therefore warranted. Specifically, the Commission should require shares offered through crowdfunding to incorporate the protections against dilution that institutional and angel investors are typically able to negotiate to protect their interests. Such an approach would also make it easier for investors to compare securities offered by different crowdfunding issuers, potentially enabling them to make better choices and allocate their capital more efficiently.

G. The proposal to “harmonize” disclosure requirements would reduce transparency and weaken investor protections.

Rule 506(b) is by far the most popular offering exemption among issuers, despite the fact that it imposes tight restrictions on sales to non-accredited investors. Specifically, issuers are permitted to sell to as many as 35 non-accredited investors who either in their own right, or by virtue of the fact that they purchase through a purchaser representative, are deemed to be sophisticated, but only if the issuer provides those non-accredited investors with specified financial statement information, along with non-financial information. The information must be provided a reasonable time prior to the sale, and the investors must have an opportunity to ask questions and receive answers about the offering. Now, the Commission proposes to water down the financial information requirements for the vast majority of Rule 506(b) offerings -- offerings by non-reporting companies of up to \$20 million -- by eliminating the requirement to provide audited financial statements.

The Commission’s explicit goal in proposing this change is to encourage more issuers to include non-accredited investors in their offerings pursuant to Rule 506(b) and thus “expand investment opportunities for those investors.”¹⁷⁴ Although the Commission posits, in typical

¹⁷² Release at 157.

¹⁷³ Final Rule, Crowdfunding, Release Nos. 33-9974; 34-76324; File No. S7-09-13, October 30, 2015, <https://bit.ly/2yWQ4mx>.

¹⁷⁴ Release at 95.

fashion, that the proposed change “*might* allow non-accredited investors to construct a more efficient portfolio,”¹⁷⁵ it fails to provide any concrete evidence that non-accredited investors are likely to benefit from these “expanded opportunities” or that the potential “benefits” of non-accredited investor access to Rule 506 offerings outweigh the very real potential harms. This is a significant omission, since the Commission itself acknowledges that the proposal comes with significant risks. As the Commission states in the proposing release, “to the extent that audited financial statements are valuable for informed investment decisions, scaled disclosures in offerings of up to \$20 million might cause some non-accredited investors to incorrectly value the offered securities and to make less well informed investment decisions. Further, the proposed elimination of audit requirements for disclosures to non-accredited investors in Rule 506(b) offerings of up to \$20 million might encourage some issuers with relatively higher information risk to sell securities to non-accredited investors given the absence of investment limits in such offerings.”¹⁷⁶

The Commission suggests that the “requirement that non-accredited investors must satisfy the knowledge and experience standard of Rule 506(b)(2)(ii) in order to be eligible to participate in an offering under such rule is expected to mitigate some of these costs.”¹⁷⁷ We disagree. First, sophistication cannot fully substitute for access to information. Second, the rule leaves unsophisticated investors vulnerable to self-interested recommendations from purchaser representatives with an incentive to push the offering. In 2014, the SEC’s Investor Advisory Group recommended that the Commission strengthen the protections that apply when non-accredited individuals, who do not otherwise meet the sophistication test for such investors, qualify to invest solely by virtue of relying on advice from a purchaser representative. It stated that, “the Commission’s rules do not ... achieve an appropriate balance. They 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.”¹⁷⁸

Before moving forward with a proposal to expand non-accredited investor access to Rule 506(b), the Commission has an obligation to more carefully study what the likely impact would be on investors. Of course, that would require the Commission to collect and analyze data on the Reg. D market, including how investors in Reg. D offerings fare and how successful it is in promoting sustainable job creation. And that is something the Commission has steadfastly refused to do, perhaps because it fears that the data would not support its deregulatory agenda.

¹⁷⁵ *Id.* at 216-217.

¹⁷⁶ *Id.* at 213-214.

¹⁷⁷ *Id.* at 214. The Commission also cites the fact that the number of non-accredited investors would be capped as affording some degree of investor protection, but it is simultaneously proposing to significantly expand the number of non-accredited investors an issuer could sell to in a single year by shortening the cooling off period between offerings.

¹⁷⁸ Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014), <https://bit.ly/3dyeQsk>.

Until it conducts that analysis, the Commission will not have a sufficient basis for proposals, such as this, designed to expand non-accredited investor access to exempt offerings.

II. The Commission hasn't conducted serious economic analysis to support its proposal.

As we discussed at length in our earlier comment letter on the Concept Release, offering exemptions have undergone extensive revisions in the last decade. These have included: the introduction of general solicitation to the Reg. D market with the advent of Rule 506(c) offerings; the introduction of an entirely new, online crowdfunding market for micro offerings; substantial increases in the offering limits for Reg. A and Rule 504 offerings, and the repeal of Rule 505 of Reg. D. Together, these and other changes have provided issuers at every stage of their development with expanded options for raising capital through exempt offerings. What these changes have in common is that they reflect a dramatic shift in regulatory priorities, from the Commission's traditional focus on ensuring that issuers who wish to raise money from the general public provide the full and fair disclosure demanded in our public markets to a new focus on providing issuers with a multitude of options for raising capital from the general public without bearing the "burden" of full disclosure.

This latest proposal is consistent with that deregulatory trend. But it comes at a time when serious questions have been raised about the declining health of our public markets, and the role of expanded access to private markets in that decline, and amid evidence of serious compliance failures in some corners of the private markets. This raises questions about the likely impact of these proposals on investor protection, market integrity, and capital formation. The Commission has an obligation to consider those impacts, but it has failed to do so here. That is not because the Commission staff is incapable of such an analysis. Instead, it reflects a willingness at the top of the agency to allow ideology rather than analysis to drive regulatory policy, including a refusal to even consider policy changes that would enable the Commission to collect the necessary data for its economists to analyze.

A. The Commission has not compiled data or done any analysis that would enable informed decision-making regarding this set of issues. In fact, the Commission readily admits it does not know what effects the proposals would have, either individually or in aggregate.

The changes that have already been made to expand private offering exemptions can reasonably be expected to have affected the decisions issuers make regarding whether to conduct an exempt offering and, if so, what exemption to use. As such, these changes have potentially profound implications for investors, both those who participate in private offerings and those who do not. Responsible regulation demands that the Commission pause to consider these effects before proceeding with a new round of regulatory changes that further tip the scale in favor of private offerings. But efforts by the Commission to study the impact of these developments, whether in the form of the 2019 report on Capital Raising in the U.S. or the "analysis" in the Concept Release that paved the way for this proposal, reveal instead the scale of the

Commission's ignorance when it comes to private markets that now dwarf our public markets in size.¹⁷⁹

Among the many questions the Commission cannot answer are: Who invests in private offerings, why, and how do those investments fare? Are issuers even interested in attracting additional small investors? How does that differ between private funds and operating companies that rely on exempt offerings to raise capital? How successful are private offerings in promoting sustainable capital formation and job growth? And what effect has the expansion of exempt offerings had on investor protection and market health?¹⁸⁰ Despite its ignorance about everything it would need to know to determine whether its latest proposals are warranted, whether they would likely benefit or harm investors, and what their impact would be on capital formation and market health, the Commission proposes to forge ahead with a new round of deregulatory changes.

We discuss above the Commission's lack of knowledge about the key issues underlying each of the proposals individually. But that lack of knowledge is magnified without regard to the likely impact of the proposal when taken as a whole. The Commission acknowledges as much. For example, the Commission notes that the interplay between the various aspects of the proposal are hard to predict, stating, "Some of the proposed amendments affect the same offerings and issuers or have mutually reinforcing or partly offsetting effects, which makes it more difficult to draw conclusions about the net effects of the proposed amendments package as a whole. For example, it is difficult to predict how the amendments that expand, simplify, and increase the uniformity of integration safe harbors will affect issuer reliance on individual exemptions." Elsewhere, the release states, "The resulting composition of the issuers that would rely on these exemptions [Regulation A, Regulation Crowdfunding, and Rule 504] remains unclear...."

The Commission admits, moreover, that its inability to predict the likely effects of the proposal stem in part from the fact that it hasn't sought out data that would enable informed decision-making. The release states, for example, "Because reliance on integration safe harbors is not required to be disclosed, we lack a way to reliably quantify the pool of issuers and offerings that would be affected by the proposed approach to integration." With regard to the resulting composition of issuers that would rely on Reg. A, Reg. CF, and Rule 504 as a result of the proposed changes, the Commission admits there are many factors at play and, "We lack the data, or a methodological approach, to disentangle these competing effects." Further, the Commission admits that it "lack[s] the data to assess how many investors would be affected by the proposed amendments to Regulation Crowdfunding investment limits, in part because investor information generally is not available and is not required to be disclosed in the course of an offering or upon completion of an offering." Elsewhere, in a footnote, the Commission admits that "comprehensive data on the investment returns resulting from investments in exempt

¹⁷⁹ See, e.g., 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.").

¹⁸⁰ See Letter from SEC Investor Advocate Rick A. Fleming, to the SEC, July 11, 2019, <https://bit.ly/3c1gmwo>.

offerings is scarce due to the scaled disclosure requirements and a lack of a secondary trading market.” Similarly, as we have noted before, the Commission’s failure to enforce the Form D filing requirement, and to collect adequate data about Rule 506 offerings on Form D, leaves it largely ignorant about this largest of private markets.

The Commission appears to rely on the fact that “data is scarce” to justify moving forward without a reasonable basis for predicting the likely impact of its proposals on issuers, investors, and the market as a whole. But that data scarcity is a self-inflicted wound, resulting from policy choices the Commission has made, and the Commission has broad authority to fix it. That’s why we and others, including state securities regulators, have repeatedly called on the Commission to first close serious gaps in its data collection and then carefully analyze that data before moving forward with proposals that, by its own admission, have the potential to result in considerable investor harm. The Commission’s refusal to do so suggests that it rightly fears that data collection would undermine its deregulatory agenda.

Even as it forges ahead based on unfounded, pollyannaish statements about the “opportunities” its proposals would provide investors to invest in companies with “high-growth potential,” the Commission is forced to acknowledge, at least in passing, that there are good reasons to believe those benefits will fail to materialize. The Commission concedes, for example, that the proposed changes might result in adverse selection, such that less attractive offerings end up being sold to the least sophisticated investors. The release states, “Issuers with worse prospects that are unable to attract capital from large investors, which undertake more monitoring and screening, might be overrepresented among exempt offerings focused on non-accredited investors. This mechanism might contribute to quality sorting in an expanded set of investment opportunities in exempt offerings to non-accredited investors.” That is a serious risk, which the Commission promptly ignores.

Similarly, the Commission is forced to admit that, while it “intends” for the proposed changes to result in non-accredited investors’ experiencing better portfolio efficiency, that “would depend on the level of investor sophistication in obtaining and analyzing information in a setting where issuers provide less disclosure compared to registered offerings.” But the Commission knows from its own extensive research that the vast majority of retail investors lack the necessary sophistication.¹⁸¹ It concedes, moreover, that these vulnerable investors’ lack of bargaining power could result in an inability to negotiate beneficial terms relative to other market participants, and that these investors will thus have even more work to do to protect themselves from being sold bad deals. It states, “non-accredited investors that tend to hold minority stakes might need to perform additional due diligence, given potential differences in the payoffs obtained by accredited versus non-accredited investors.”

In short, given the lack of sophistication and bargaining power of the typical non-accredited investor, the great “opportunities” that the Commission touts will be accessible by investors of all stripes are likely to be nothing more than a deregulatory pipe dream. At the very least, the Commission has an obligation to understand the likely impact of its proposed changes,

¹⁸¹ See, e.g., SEC Staff, Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, August 2012, <http://1.usa.gov/1fMABVZ>.

something it has entirely failed to do here. With the weight of the evidence suggesting its proposals would do considerably more harm than good, the Commission cannot reasonably move forward without a much more extensive and careful analysis.

B. The Commission continues to willfully ignore critical questions about exempt offerings and their interplay with public markets.

Among the key factors the Commission has an obligation to consider when redrawing the lines between public and private markets is what the impact would be on the health of the markets as a whole. As we discussed at length in our comments on the Concept Release, the nation has experienced a troubling decline in the number of public companies and the number of IPOs in recent decades. We have seen a parallel rise in the number of large private companies with a broadly dispersed shareholder base that fail to provide the transparency appropriate for companies of their size and influence. Because it puts its thumb on the scale in favor of private capital raising, this proposal has the potential to make those problems worse, with potentially harmful consequences for both individual investors and the health of the overall economy.

The Commission makes no secret of the fact that one of its goals for the current proposal is to make it easier to raise unlimited sums of money in private markets through exempt offerings. Should it succeed in achieving that goal, as we believe it would if it were to finalize these ill-considered proposals, it would further diminish issuers' need or incentive to tap public markets through registered offerings. More specifically, if a company can easily get unlimited money from private investors under the radar, including by stringing together multiple exempt offerings that are part of one overarching financing scheme without fear that they'll be integrated, if it can engage in general solicitation and advertising to the general public without fear that the Commission will police it as such or actually require the issuer to take reasonable steps to verify accredited investor status where it is required, if it can sell to a large and diffuse shareholder base without fear that doing so would trigger 12(g) thresholds, if it can increase the amount of capital it raises via various exemptions, why wouldn't it do so? And if it can raise capital in private markets, thereby ensuring that the company and its insiders effectively remain unaccountable -- to regulators, to investors, and to the general public -- why would it go through the registration process, which promotes accountability?

In short, given the strong likelihood that the Commission's proposals would further undermine the need and incentives companies have to go public or become publicly reporting companies, the Commission has a clear obligation to carefully consider the impact its proposal would have on the health of the public markets. But it entirely fails to do so here.

C. 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.¹⁸² That bias is reflected here. But as we discussed at length in our letter on the Concept Release, the evidence regarding private offerings' role in promoting sustainable job creation -- capital formation as opposed to mere capital raising -- is far more mixed and nuanced than proponents of a deregulatory agenda, such as the one being advanced here, are prepared to admit.¹⁸³

This distinction between capital formation and mere capital raising is directly relevant to the issues addressed in this proposal. A crucial question for the Commission to ask before proceeding with this 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, with little net impact on employment as a whole? 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?

The release itself suggests that providing capital to small issuers through private offerings doesn't necessarily put them on a trajectory to grow and ultimately go public. For example, the release states that, "we have identified only one Regulation Crowdfunding issuer that has undertaken a registered offering as of December 31, 2019."¹⁸⁴ It adds that, "very few Regulation A issuers have undertaken a registered offering during this period, resulting in a lack of reliable data on such issuers' registered offering proceeds."¹⁸⁵ If, as the release suggests, few companies that rely on these offering exemptions are making the transition to public markets, what are the implications? What has happened with all of crowdfunding and Reg. A issuers since receiving funding? Does the Commission have any idea what percentage of them have gone on to grow and create jobs and what percentage have gone out of business or gone bankrupt? Does the Commission have any idea what kind of compensation programs the founders and executives got?¹⁸⁶ And how have investors fared?¹⁸⁷

Other questions come to mind. In keeping with the premise that transparency promotes efficient allocation of capital, a premise that the Commission itself purports to embrace, would that record of success and failure among private offerings have been different if more, or more reliable, information had been available about the companies in question? Does the extensive use

¹⁸² See, e.g., 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.")

¹⁸³ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY>.

¹⁸⁴ Release at 230, note 406.

¹⁸⁵ *Id.*

¹⁸⁶ We've observed several instances in which executives of Reg. A issuers that are operating deep in the red while collecting between \$400,000 and \$500,000 a year.

¹⁸⁷ We have no doubt that if the Commission asked its staff to come up with a research plan to answer these questions, the staff would be able to do so. Instead, the Commission appears content to proceed in ignorance.

of exemptions reduce real opportunities from investors in public markets, where the protections are stronger and investors enjoy privileges they don't get in private markets? Does encouraging companies to go public foster more accountable companies -- to regulators, investors, and the public -- and does that greater accountability in turn improve corporate governance and company policies and practices? Like much else of importance here, these are questions 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."¹⁸⁸ There are good reasons to believe that policies that favor private markets over public markets put that record of success at risk. It is far from clear, for example, 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 several decades of policies to promote private markets as well as the proposals under consideration here.

At the very least, given the growing dominance of private markets and the precarious state of our public 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 has the ability to gather data needed to answer these questions, including by looking 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. Similarly, it could look at a random sample of companies' offering documents, such as Form 1-A and Form C, to determine whether the terms on which Reg. A and crowdfunding offerings respectively are sold are favorable or unfavorable to the purchasers. For example, we understand that many of these offerings limit investor rights significantly and all but guarantee the investor's ownership interest will be diluted.¹⁸⁹ These offerings can also have extremely unfavorable terms that make it highly unlikely the investor will experience a positive outcome.¹⁹⁰ This sort of analysis is critical before undertaking an expansion of private offering exemptions. Unfortunately, the Commission hasn't even attempted to conduct any of this type of critical analysis, or even acknowledge the need to do so.

¹⁸⁸ Laura Anthony, NASDAQ Issues Report Advocating for The U.S. Public Markets, Anthony L.G. PLLC, October 24, 2017, <http://bit.ly/2mIuPhT>.

¹⁸⁹ For example one Reg. A issuer that we observed issued common stock that provided holders less than 0.005% of total voting power. Another issuer stated that, "Purchasers of our common stock in this offering will experience immediate and substantial dilution of the net tangible book value of their common stock from the initial public offering price..." Another issuer "restricts the ability of individual investors to bring class action lawsuits or to similarly seek remedy on a class basis..."

¹⁹⁰ One Reg. A issuer admits that, "The offering price of our shares was not established on an independent basis...Our Manager established the offering price of our shares on an arbitrary basis. The selling price of our shares bears no relationship to our book or asset values or to any other established criteria for valuing shares."

D. 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. Experience tells us, moreover, that retail investors are particularly susceptible to suffering from fraud, which raises serious questions about proposals to increase their access to private markets. According to Professor Elizabeth Pollman, there is “great potential for harm, particularly to unsophisticated shareholders and other stakeholders,” as a result of fraud in private markets.¹⁹¹ 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. Yet the increased fraud risk to investors posed by its proposal barely merits a passing reference in the release -- far from the serious consideration responsible regulation demands.

The following specific examples of private placement fraud and other predatory practices highlight how investors can be harmed in loosely regulated private markets. Many of these were discussed in our earlier comment letter on the Concept Release, but continue to be ignored by a Commission apparently intent on rushing through its deregulatory agenda.

For many years, abuses associated with private offerings have been at the top of state securities regulators’ list of concerns. For example, 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.”¹⁹² “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.¹⁹³

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.¹⁹⁴ According to NASAA’s 2017 report, “Investigations of senior financial exploitation most often involve unregistered

¹⁹¹ Elizabeth Pollman, *Private Company Lies*, 109 *Geo. L.J.* __ (forthcoming 2020), <https://bit.ly/2XXbnNh>.

¹⁹² 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>.

¹⁹³ Jean Eaglesham and Coulter Jones, *Opportunities to Invest in Private Companies Grow*, *Wall Street Journal*, September 23, 2018, <https://on.wsj.com/2mDpCHZ>.

¹⁹⁴ NASAA Enforcement Section, *NASAA 2018 Enforcement Report Based on 2017 Data*, <https://bit.ly/30fceLM>.

securities offerings.”¹⁹⁵ 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.”¹⁹⁶

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 accredited investor households are retirees.¹⁹⁷ According to the *Journal*’s analysis, over 16% 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.¹⁹⁸ 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. We documented at length in our comment on the Concept Release many of these efforts.¹⁹⁹ 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.”²⁰⁰

Meanwhile, the Commission itself simply doesn’t have the resources to detect and deter the type of smaller-scale frauds likely in the private markets. And some of the changes adopted to exempt offerings in recent years have undermined the ability of state securities regulators to detect and deter violations of the federal and state securities laws to protect their citizens.²⁰¹ 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

¹⁹⁵ NASAA Enforcement Section, NASAA 2017 Enforcement Report Based on 2016 Data, <https://go.aws/30erJ73>.

¹⁹⁶ NASAA Enforcement Section, NASAA 2014 Enforcement Report Based On 2013 Data, <https://bit.ly/3cAlr41>.

¹⁹⁷ Jean Eaglesham and Coulter Jones, Opportunities to Invest in Private Companies Grow, *Wall Street Journal*, September 23, 2018, <https://on.wsj.com/2mDpCHZ>.

¹⁹⁸ *Id.*

¹⁹⁹ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, October 1, 2019, <https://bit.ly/3cl8wCY> (documenting NASAA action against LPL, Massachusetts investigation into broker-dealer firms’ sales practices in connection with private placements following a *Wall Street Journal* investigation, Massachusetts action against Securities America for its role in selling fraudulent and worthless MedCap securities, Massachusetts investigation into broker-dealers’ sales practices of private placements by GPB Capital Holdings, and the Woodbridge Ponzi scheme, for example).

²⁰⁰ FINRA, Report on FINRA Examination Findings, December 2018, <http://bit.ly/2I5hCPz> (finding that some firms failed to perform reasonable diligence on private placement offerings prior to recommending the offerings to retail investors, over-relied on third parties, and failed to consider the related conflicts of interest of third-party due diligence report providers that issuers paid for in their evaluation and assessment of the reports’ conclusions and recommendations).

²⁰¹ 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.

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.

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, taking into account its own limited resources for oversight and enforcement. 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. Specifically, the Commission has an obligation to try to understand the extent to which fraud pervades private markets, and how that impacts financially unsophisticated investors in particular. It should then factor these considerations into its analysis and, ultimately, its regulatory approach. Instead, the Commission ignores this issue entirely, relying on the fact that the anti-fraud provisions of the '34 Act still apply in private markets without assessing their effectiveness in preventing fraud. As the Commission surely understands, however, an anti-fraud action can only be brought if the fraud is detected. Because there is little to no information about private company activities, it is extremely difficult to detect fraudulent practices and bring successful enforcement actions.

Recent academic articles have highlighted this problem. For example, Professor Verity Winship recently published an article that examines “one societal cost of the decline of public companies: the loss of information needed to detect and punish fraud.”²⁰² Similarly, Professor Elizabeth Pollman recently published an article that highlights how “the explosive growth of private markets has left huge portions of U.S. capital markets with relatively light securities fraud scrutiny and enforcement.”²⁰³ Pollman’s article in particular discusses how private markets are prime environments for fraud. In particular, she points to the “extreme information asymmetry” and discusses how “the pressure, opportunity, and rationalizing culture...can foster misconduct and deception.”²⁰⁴

Both articles also highlight the ineffectiveness of the anti-fraud provisions in reducing this fraud risk. The Commission has repeatedly warned, in recent years, that these antifraud provisions apply regardless of whether a security is public or private,²⁰⁵ and the release repeatedly points to the Commission’s antifraud authority as ensuring the proposed expanded exemptions would be sufficiently protective of investors.²⁰⁶ But Pollman notes in her article that,

²⁰² Verity Winship, *Private Company Fraud*, University of Illinois College of Law, 2020, <https://bit.ly/3gMVy4f>.

²⁰³ Elizabeth Pollman, *Private Company Lies*, 109 *Geo. L.J.* __ (forthcoming 2020), <https://bit.ly/2XXbnNh>.

²⁰⁴ *Id.*

²⁰⁵ *See, e.g.*, Press Release, SEC “Theranos, CEO Holmes, and Former President Balwani Charged With Massive Fraud; Holmes Stripped of Control of Company for Defrauding Investors,” (March 14, 2018) <https://bit.ly/2zMjaWh> (quoting Steven Peikin, Co-Director of the SEC’s Enforcement Division, stating that the action against Theranos, Elizabeth Holmes, and Ramesh “Sunny” Balwani sent a message that “there is no exemption from the anti-fraud provisions of the federal securities laws simply because a company is non-public, development-stage, or the subject of exuberant media attention.”).

²⁰⁶ Release at 188-189 (“the proposed amendments require that issuers continue to meet the conditions of each exemption they are relying upon, and because investor protection provisions of each exemption as well as *general anti-fraud provisions* would continue to apply, we believe that the proposed amendments would not have significant adverse effects on investor protection.”); Release at 74-75 (“We believe that the proposed exemption would be consistent with the protection of investors. As with the existing test-the-waters provisions of Rule 163B and Regulation A, *the anti-fraud provisions of the federal securities laws would apply* to these generic solicitations of

“there is no sign that [public enforcement] has kept pace with recent developments.”²⁰⁷ Similarly, Professor Winship’s article highlights the fact that the Commission brought only a handful of enforcement actions against private companies between Oct. 1, 2015 and Sept. 30, 2019 based on a violation of Exchange Act Section 10 and/or Securities Act Section 17. Pollman concludes, “[T]he relative infrequency of actions has given an empty tone to the SEC threat.”²⁰⁸

Given the Commission’s sweeping lack of knowledge about what’s happening in private markets, as evidenced in both this proposal and the earlier Concept Release, it is not surprising that the Commission has struggled to detect frauds in these markets and has been missing in action with regard to fraud enforcement. While it may not take a sleuth to detect a massive fraud of a high-profile company, such as Theranos, that was already uncovered by an in-depth *Wall Street Journal* investigation, for example, the vast majority of private companies that are not the subject of such public scrutiny are likely to fly under the Commission’s radar. Even if the Commission could detect all of the fraud that occurs in exempt markets, it simply doesn’t have the resources to effectively police these markets, given their size, the number of issuers and offerings, which are orders of magnitude larger than public markets. Without the realistic threat of enforcement, many private companies are unlikely to be deterred from engaging in fraud and other unlawful activity, and investors, particularly vulnerable retail investors, will suffer.

E. The Commission has conveniently ignored the wide dispersion of returns in private markets.

One of the assumptions underlying the release is that investors of all stripes can do better investing in private markets than they can in public markets. Accordingly, the Commission wants all investors to have access to the same “high-growth” investment opportunities that the most sophisticated, well-heeled institutional investors have. The Commission has no basis for this assumption, a fact it admits, albeit buried deep in a footnote. The Commission first admits that it has no idea what market-wide investments returns look like, stating, “Comprehensive, market-wide data on the returns of private investments is not available due to a lack of required disclosure, the voluntary nature of disclosure of performance information by private funds, and the very limited nature of secondary trading in these securities.”²⁰⁹ The Commission further acknowledges, at least indirectly, that non-accredited retail investors are unlikely to have access to the same types of deals as the most sophisticated institutional investors and are therefore

interest.”); Release at 219-220 (“The existing requirement that the non-accredited investor satisfy the knowledge and experience standard of Rule 506(b)(2)(ii), as well as *the continued application of the anti-fraud provisions of the federal securities laws*, might mitigate some of the investor protection risks under this alternative.”); Release at 254 (“The required transparency and single-purpose nature of the crowdfunding vehicle, combined with the continued application of the substantive and disclosure requirements of Regulation Crowdfunding and *the anti-fraud provisions of the federal and state securities laws*, are expected to provide significant investor protections for crowdfunding vehicle investors under the proposed rule.”) (emphasis added).

²⁰⁷ Elizabeth Pollman, *Private Company Lies*, 109 *Geo. L.J.* ___ (forthcoming 2020), <https://bit.ly/2XXbnNh>.

²⁰⁸ Pollman also discusses how, for a variety of reasons, “securities fraud class actions have been absent in the private market.” According to Pollman, “Although contested, private class actions are understood to serve a monitoring and deterrence function—something that the private capital market needs. A variety of factors may explain why securities class actions have not played a significant role to date in the private capital market: the lack of fluid pricing to identify potential suits, impediments to aggregate litigation, and the different economics of the lawsuit.”

²⁰⁹ Release at 169, note 372.

unlikely to experience the same returns. It states, “As an important caveat, risk-adjusted returns obtained by large institutional investors in private placements may not be an accurate representation of the returns that would be obtained by non-accredited investors.”²¹⁰

This is reinforced by the fact that the proposal expands retail investor access to private offerings that, by the Commission’s own admission, are likely to be of little interest to institutional investors. For example, in explaining why the Commission chose not to limit test-the-waters communications in private offerings to QIBs and IAIs, as it had for registered offerings, the release states, “there is likely to be relatively limited institutional investor interest in many types of exempt offerings, particularly those that rely on general solicitation.”²¹¹ In other words, the Commission is well aware that retail investors’ experience in private offerings is likely to be very different from, and far inferior to, the experience of sophisticated institutional investors, but it chooses to promote their “access” to these offerings anyway. This suggests that its goal of these proposals is to benefit private issuers, even at the expense of retail investors.

The fact that retail investors are likely to enjoy much worse returns in private markets than institutional investors takes on added importance, because differences in returns are much greater in private markets than they are public markets. This phenomenon has been well documented in the private equity market, for example. According to a recent JPM report, “The dispersion of returns among private equity investments is substantial in absolute terms and relative to other segments of the investment universe.”²¹² Specifically, the JPM report found that average dispersion of returns from top to bottom quartile among private equity funds is over 1,900 basis points (a full 19 percentage points). The report highlighted the importance of conducting in-depth due diligence and “‘invest[ing] with the best’ on a consistent basis” in order to meet the return enhancement potential that private equity can offer, something that is exceedingly difficult to do. The report concluded, “It is our view that the return enhancement objective will not be achieved by merely matching average or median industry performance.”²¹³ If, due to adverse selection and their inability to conduct the necessary in-depth due diligence, retail investors receive below average performance, they will be harmed, not helped, by their access to these investment “opportunities.”

As significant as this return dispersion is among private equity funds, private equity fund performance is likely to be much better than the performance received by a non-accredited retail investor who purchases exempt offerings directly. After all, the typical bottom quartile private equity fund manager is still likely to be vastly more financially sophisticated, and thus far more able to spot and access high-quality deals than the vast majority of individual accredited

²¹⁰ *Id.*

²¹¹ *Id.* at 76.

²¹² J.P.Morgan Asset Management, Portfolio Insights, Investing in private equity, Essentials for achieving enhanced private equity returns, February 2018, <https://bit.ly/3eMrILB>.

²¹³ *Id.* See also Andrea Auerbach, Are Private Equity Returns Doomed?, Cambridge Associates, January 2017, <https://bit.ly/3csnBCw> (“Longtime observers of private equity know the return dispersion of private equity funds is immense and second only to the return dispersion of venture capital funds. There is no ‘index hugging’ in private equity. Even in a market where the vast majority of investments are ‘won’ in an auction process and sponsor-to-sponsor investing is on the rise, any given vintage year will show an average dispersion of 1,400 basis points* (bps) between the top quartile fund and the bottom quartile fund. Larger US private equity funds have a 780 bp dispersion between the top quartile and bottom quartile funds, and smaller funds experience more than twice that.”).

investors, let alone non-accredited retail investors. Thus, the return dispersion between non-accredited investors' investments in exempt offerings and the top quartile of private equity funds is likely to be even greater than between top and bottom quartiles of private equity funds.

The predictable result of channeling different types of investors to different types of offerings would be that this proposal would perpetuate a two-tier market of haves and have-nots. Financially sophisticated institutional investors with significant resources and insider access will be able to participate in the best deals on the most favorable terms with the greatest likelihood of superior performance. Meanwhile, financially unsophisticated non-accredited retail investors, who do not have significant resources or insider access, will be relegated to the worst deals on the least favorable terms with the greatest likelihood of failure.

Thus, instead of making more "high-growth" opportunities available to non-accredited retail investors, this proposal would expose vulnerable investors, who need to make every investment dollar count, to unaffordable losses in risky private offerings. Because the Commission has failed to conduct an even minimally credible economic analysis, and because the limited available evidence suggests its proposal is more likely to harm than to benefit investors, the Commission should withdraw this proposal.

III. Conclusion

This proposal represents a sweeping redrawing of the line between public and private markets, with the express purpose of making it easier both for issuers to raise capital in exempt offerings and for average retail investors to gain access to those offerings. But the Commission never stops to ask whether that is an appropriate goal. It never seeks to determine what the effect would be on the overall health of our capital markets of a proposal that favors private offerings over public offerings. It never seeks to determine whether average retail investors would be more likely to benefit from increased access to such offerings or suffer increased financial harm. Indeed, either because it is operating on blind faith regarding the benefits of its proposal or because it prioritizes satisfying the demands of business groups over protecting investors and promoting healthy markets, the Commission appears throughout this release to be disturbingly indifferent to the potentially harmful impact of its proposals on investors and markets alike.

This lack of balance pervades the release. On issue after issue, concerns of business groups are prominently featured while concerns of investors and state securities regulators are buried in the footnotes. It is emblematic of the extent to which the Commission prioritizes business interests over investor interests that it gives great deference to the recommendations it has received over the years from various industry advisory groups, while entirely ignoring recommendations of its Investor Advisory Committee that are directly relevant to these proposals. If the business group recommendations were backed by more rigorous research or data, this might be understandable, but they are not. On proposal after proposal in this release, the Commission responds to anecdotal industry "concerns," while acknowledging its complete lack of data to support those claims. Meanwhile, empirical research that conflicts with its preferred approach is, like the concerns of investors and state securities regulators, relegated to the footnotes.

This lack of balance is also evident in the questions on which the Commission seeks comment. It asks, for example, whether the Commission should deregulate offers entirely²¹⁴ and whether it should further deregulate secondary trading of exempt securities -- raising the possibility of even more giveaways to issuers and the financial industry. Not once does the Commission seriously question whether investors and markets would benefit from a narrowing of the exemptions, even as Commission leaders separately voice concern over the health of public markets.

This proposal is evidence of an agency that has abandoned its investor protection mission and shirked its responsibility to protect the health and integrity of our capital markets. It should be withdrawn and the Commission should recommit itself to what it claims is its primary goal, to “promote a market environment that is worthy of the public's trust.”²¹⁵

Respectfully submitted,



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Director of Investor Protection



Micah Hauptman
Financial Services Counsel

cc: Chairman Jay Clayton
Commissioner Hester M. Peirce
Commissioner Elad L. Roisman
Commissioner Allison Herren Lee

²¹⁴ Release at 68-69 (“Should we instead eliminate all prohibitions on “general solicitation” and “general advertising” and focus investor protections at the time of sale rather than at the time of offer?”); Release at 137-138 (“Should we preempt state securities registration or other requirements applicable to secondary sales of all securities initially issued in a Tier 2 Regulation A offering? Should we preempt state securities registration or other requirements applicable to secondary trading of securities only of Regulation A Tier 2 issuers that are current in their ongoing reports? Should we similarly preempt state securities registration or other requirements applicable to secondary trading of securities of initially issued in a Regulation Crowdfunding offering?...What other steps should we consider to improve secondary trading liquidity of securities exempt from registration under Regulation A or Regulation Crowdfunding?”).

²¹⁵ U.S. Securities and Exchange Commission, About the SEC, What We Do, <http://bit.ly/2MngEXy> (last visited June 3, 2020).