

September 24, 2019

By Email: ([rule-comments@sec.gov](mailto:rule-comments@sec.gov))

Secretary

Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549-1090

Re: File Number S7-08-19, *Harmonization of Securities Offering Exemptions*

To whom it may concern:

CFA Institute<sup>1</sup> appreciates the opportunity to comment on the concept release: *Harmonization of Securities Offering Exemptions*. We thank the Securities and Exchange Commission (the “SEC” or “Commission”) for explaining the current registration exemptions structure and the proposed changes to that system in a straightforward and clear manner.

We agree that the current exempt offering framework is complicated with differing requirements and conditions for different types of offerings. These complications may be difficult for issuers to navigate because they bear the burden of demonstrating the availability of any exemption. Managing these complications may be most difficult for smaller companies with more limited resources, who are more likely to need such exemptions to endure the costs associated with conducting a registered offering and becoming a reporting company.

Nevertheless, we believe any changes to the exemption system will have profound implications on both institutional and individual investors. Some of the changes to the current exemption system discussed in the SEC’s proposal may expose a broader range of investors to financial risks they do not adequately understand. Loosening the definition of an accredited investors may result in more investments that are inappropriate for individual investors. Therefore, we caution the Commission to take all investor feedback into account when making any changes to the exemption system.

### **Is there a need for changes?**

The Concept Release posits that changes to the exemption system to allow more investors to participate in exempt offerings would allow companies to better access capital that they otherwise would not be able to access. We ask the Commission to provide more evidence that such an increase in access to capital would be the result of a relaxation of exemption standards.

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<sup>1</sup> CFA Institute is a global, not-for-profit professional association of nearly 160,800 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than 154,700 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 155 member societies in 77 countries and territories.

In “Capital Formation: The Evolving Role of Public and Private Markets,”<sup>2</sup> CFA Institute cites two academic reports noting the benefits that come from public capital markets. Those benefits are, namely, 1) a large and deep pool of capital to fund new ventures; 2) the lowest cost means of raising large amounts of capital; 3) a currency to use for future acquisitions; and 4) use of an initial public offering as a “strategic, reputation-enhancing move.”<sup>3</sup> Beyond these benefits, public capital markets have created significant benefits for investors of which the Commission is well aware, such as liquid trading markets that enable investors to quickly monetize their holdings at low-cost.

At the same time, changes to the National Securities Markets Improvement Act of 1996 made it easier, and therefore cheaper, for companies “to sell securities to qualified purchasers” in private transactions. Among the changes was exemption from “blue sky” laws, which had previously imposed significant restrictions on the sale of unregistered securities. Another was an increase in the maximum number of investors who could invest in an unregistered fund, thereby enabling venture capital and private equity funds to raise more capital they could invest in late-stage, more capital-intensive business startups.<sup>4</sup>

The above changes reflect generally positive innovations in allocating scarce financial resources to companies looking to fund development and growth. Nevertheless, we still believe society, in general, and issuers and investors in particular, have benefited in the past, and will benefit in the future from public capital markets. Regardless, we believe the Commission should focus attention to enhance the efficiency and transparency of all capital markets to ensure economic benefits for investors and issuers, alike.

While we may support changing the definition of accredited investors to include individuals who, though they have professional experience in investment markets, may not possess the wealth or annual income required under current law, we are still wary of further relaxing investor protections to give issuers access to capital. Given the changes noted above, we are concerned investors in exempt offerings will not have the kinds of financial and market information they are accustomed to receiving in public capital market transactions. Moreover, we are concerned about protecting investors who lack the savvy or access to capable investment or legal counsel of those currently covered under the current exemption system.

Consequently, we believe the SEC should limit revisions to the definition of accredited investor to include only those investors whose professional experiences include active buying and selling of securities, or whose professional credentials indicate a high degree of understanding of investment markets.

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<sup>2</sup> Sviatoslav Rosov, CFA, “Capital Formation: The Evolving Role of Public and Private Markets,” (CFA Institute Capital Formation) CFA Institute (2018). <https://www.cfainstitute.org/-/media/documents/article/position-paper/capital-formation.ashx>

<sup>3</sup> CFA Institute “Capital Formation.” In particular, see De Fontenay (2017), “The deregulation of private capital and the decline of the public company,” *Hastings Law Journal*; and Brau & Fawcett (2006), “Initial public offerings: an analysis of theory and practice,” *Journal of Finance*, 399-436.

<sup>4</sup> CFA Institute “Capital Formation.” See p. 19.

### **Is there demand for exemption reform?**

Investor trust is key to successful capital markets. Without individuals who are willing to invest available funds in securities issued by companies, municipalities, mutual funds, and other types of issuers, there would be no capital markets.

One important factor in investor trust is assurance that investors have reliable, relevant, comparable, timely and sufficient information to make reasoned investment decisions. They do not need riskless investment options, but they do need clarity on the risks they face in different investment environments. The exemptions proposed by the Commission do not engender trust from the individual investor in our opinion.

Before changing the current exemption rules we caution the Commission to make sure there is sufficient demand from individual and smaller investors to justify changing the current exemption rules. We are concerned that issuers would only approach these investors for financing when they could not secure financing from traditional sources. Lowering the standards for disclosure to this group of investors (small and individual investors) has the potential to create large problems for the investors, for securities issuers, and even for the Commission.

In part, this is because smaller investors will have less information about the company than they are used to receiving and will do so without the resources of large institutional and accredited investors to help fill those information gaps. Small investors also may be unprepared to endure the illiquid nature of the investments they are buying. With no secondary market on which to sell these securities, they will likely be burdened with the asset they buy, even if they sour on the investment for whatever reason.

### **Revisiting the definition of the accredited investor**

In December 2015, Commission staff issued a report on the accredited investor definition<sup>5</sup>. The report examined the definition's history and considered comments from a variety of sources, including public commenters, the Commission's Investor Advisory Committee, the Commission's Advisory Committee on Small and Emerging Companies, and the 2014 Small Business Forum. The report considered alternative approaches to defining "accredited investor," provided staff recommendations for potential updates and modifications to the existing definition and analyzed the effects potential approaches may have on the pool of accredited investors. The report noted that any change to the definition would have to consider both the effect on investors and the supply of capital through the Regulation D market.

The current concept release acknowledges the tradeoff between using a principles-based accredited investor definition and the need for bright-line standards that investors, issuers, and advisers can understand and easily apply. In the report, the staff recommended that the Commission consider any one or more of the methods of revising the accredited investor definition described in Table below.

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<sup>5</sup> See Accredited Investor Staff Report. <https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf> The report focused on the accredited investor definition as used in Regulation D, with the understanding that any revisions to the definition should be made to the Rule 215 definition as well.

<b>Staff Recommendation</b>	<b>Responses from Commenters</b>
Retain current income and net worth thresholds, subject to investment limits	Several - supported income and net worth thresholds; - opposed or had concerns about investment limits for investors who met the thresholds; - One opposed thresholds and investment limits. - A few said the structure would add costs and complexity to capital-raising.
Inflation-adjust income, net worth thresholds that are not subject to investment limits	Some supported this; others opposed. One recommended a sophistication requirement, in addition to the thresholds; Another said qualifications should remain independent of investment limits or qualitative restrictions.
Individuals with a minimum amount of investments to qualify	A few supported this; none specifically opposed it.
Individuals with certain professional credentials to qualify	All supported this recommendation. Suggested limitations and conditions included: - minimum professional experience - professional experience with early-stage financing. - investment limits. - Qualifying credentials such as: <ul style="list-style-type: none"> <li>• Series 7, 65, 66, or 82 exams</li> <li>• certified public accountant (CPA)</li> <li>• Chartered Financial Analyst (CFA)</li> <li>• certified management accountant (CMA)</li> <li>• registered investment advisor (RIA), or registered representative (RR),</li> <li>• MBA from an accredited educational institution</li> <li>• certified investment management analyst (CIMA), or</li> <li>• experience as a securities broker, lawyer, or accountant.</li> </ul>
Individuals with experience investing in exempt offerings	Most supported the recommendation.
Knowledgeable employees of private funds qualify for investments in employers' funds	Several supported this recommendation; one opposed. Others suggested it would have limited effects.
Index all defined financial thresholds for inflation	Most supported the recommendation

Spousal equivalents who pool finances	Responses were mixed.
All entities with investments in excess of \$5M	Responses were mixed,
Grandfather issuers' existing investors that meet and continue to meet the current definition for issuers' future offerings	Most supported the recommendation
Individuals who pass an accredited investor examination to qualify	Most supported the recommendation. A few noted workability concerns, administration costs and the inability to properly measure financial sophistication or industry/investment experience. One recommended a more thorough analysis of the level of financial sophistication needed.

The following table, taken from the Commission's proposal (Table 3 in the original proposal) lays out households currently qualifying for exemptions under the existing accredited Investor criteria:

<b>Criterion</b>	<b>Number of qualifying households (standard errors in parentheses)</b>	<b>Qualifying households as % of U.S. households (Standard errors are in parentheses)</b>
Individual income threshold (\$200,000)	11.2 million (0.3 million)	8.9% (0.2%)
Joint income threshold (\$300,000)	5.8 million (0.2 million)	4.6% (0.2%)
Net worth (\$1,000,000)	11.8 million (0.3 million)	9.4% (0.2%)
Overall number of qualifying households	16.0 million (0.3 million)	13.0% (0.2%)

This information in the above table reinforces the fact that if the accredited investor definition is to include some test based on income or net worth, only about 13% of U.S. households would qualify under the current system. Unless the Commission wishes to lower the accredited investor threshold below what is reflected in the above table, only a small fraction of U.S. households would be considered accredited investors.

In general, CFA Institute believes it is appropriate to consider an investor's sophistication when determining accredited status. Meeting certain income and wealth thresholds do not automatically confer investment understanding upon an individual. While such individuals may have the financial resources to hire competent and sophisticated financial and legal counsel to help them, there is no guarantee they will hire that counsel or listen to what that counsel

recommends about specific investment opportunities. Conversely, many who do not meet the income and wealth thresholds possess sophisticated understanding of the investment process and should not be barred from investing simply because they have yet to acquire sufficient income and wealth to meet established thresholds. At the same time, it is too much to expect of the Commission to determine on a case-by-case basis who should and who should not be accredited. A generalized rule or formula is needed to make such determinations.

In general, we don't object to any of the above recommendations under certain circumstances. At the same time, we wish to avoid instances where investors are making investments that are inappropriate for them regardless of income or experience level. For example, inflation adjustments are needed to reduce the instances where less-sophisticated individuals join the ranks of accredited investors without investment sophistication. Likewise, we believe only credentials specifically related to investment understanding should meet qualify. A general master of business administration certification should not qualify because a focus on marketing, management, or business strategy may not provide sufficient understanding of the investment process.

Key to any determination, we believe, is the requirement that brokers and investment advisers "know" their customer. These individuals should serve as gatekeepers to determine whether clients should qualify as accredited investors. Such determination should hinge on whether their clients possess the financial resources or sophistication to be considered accredited investors. They also should be held accountable for inappropriate accreditation as the competent counselors hired by their clients.

### **Is there a better way to achieve the goal stated?**

It has been the goal of legislation in recent years to permit more investors access to higher-yielding, and therefore higher-risk, investment opportunities. CFA Institute did not support these initiatives when they first appeared,<sup>6</sup> in large part because of the potential for investor confusion. As a consequence of the Jumpstart Our Business Startup Act (JOBS Act), there currently exists a two-tiered marketplace where some companies adhere to a set of regulations that has made US capital markets larger than all other global markets combined, and a second one, encompassing a far greater number of securities issuers with reduced transparency and governance requirements. Most investors are unaware these different standards exist, let alone could tell which companies are bound by one or the other regulatory system.

As a way to ensure investors were better informed of this two-tiered market, CFA recommended introduction of a venture exchange structure.<sup>7</sup> Such a market can work only if transparency standards are enough that investors, issuers, and broker/dealers have sufficient faith in the companies and listing/trading venues to come to the market and participate. The goal is to give

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<sup>6</sup> See "Only 29 Percent of CFA Institute Members Want JOBS Act Passed," <https://www.cfainstitute.org/en/about/press-releases/2012/only-29-percent-of-cfa-institute-members-want-jobs-act-passed>. Also see our response to the SEC's 2012 Consultation on the JOBS Act, available at: <https://www.cfainstitute.org/-/media/documents/comment-letter/2010-2014/20120816.ashx>

<sup>7</sup> *United States Venture Market: Has the Time Come?* (2016) <https://www.cfainstitute.org/-/media/documents/article/position-paper/united-states-venture-market.ashx>

issuers access to capital, while ensuring appropriate levels of investor protections, higher than those proposed under expanded exempt securities.

A venture market would provide investors with an important disclosure that is not currently available in the market—namely, it would help investors identify those companies operating under JOBS Act exemptions from the governance and financial reporting requirements of most public companies. The vetting of companies wishing to be listed in such a venture system is thus vitally important.

This type of vetting, though more expensive up front, would help mitigate many of the problems arising from fraudulent issuers while serving the interests of all stakeholders—issuers, investors, and intermediaries alike—if the system provides certain minimum safeguards, such as the following:

- A robust vetting process to weed out bad actors in management, on the board, and in the principal investor ranks of potential venture companies
- A sponsor system in which broker/dealers, a similar group, or the exchange itself undertakes the initial due diligence on venture companies
- Annual audits, with the auditor's report included in an annual report to shareowners and investors
- Quarterly updates on performance and financial condition using data tagging to enable investor analysis
- Use of GAAP in the preparation of financial statements
- Timely disclosure of all important company news through normal public distribution channels
- Liability of company principals for fraudulent representations made in offering documents, financial statements, or company announcements delivered through these channels
- High standards of transparency and governance, deviating from best practice standards only for legitimate reasons unique to small companies

## **Conclusion**

In conclusion, we support the commission in trying to simplify and harmonize securities market exemptions. Whatever the Commission's ultimate decision, we hope the Commission listens to the voices of investors to guide them for a final set of rules and disclosures that benefit investors.

We do not object to a reconsideration of the accredited investor definition, so long as it looks at a combination of financial sophistication and resources, and relies upon brokers and investment advisers, under their fiduciary duties and best interest obligations, respectively, to determine whether an investor should be accredited or not, and then be held accountable for inappropriate accreditation. We also believe a venture exchange structure with suitable transparency and governance requirements, could be used as a means of giving retail investors the ability to invest in early-stage companies.

Should you have any question about our positions, please do not hesitate to contact James C. Allen, CFA at [james.allen@cfainstitute.org](mailto:james.allen@cfainstitute.org) or 434.227.1338; or Matt Orsagh, CFA, at [matt.orsagh@cfainstitute.org](mailto:matt.orsagh@cfainstitute.org), or 434.951.4829

Sincerely,

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