



OFFICE OF THE  
INVESTOR ADVOCATE

UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

July 11, 2019

**Submitted Electronically**

Vanessa Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F St NE  
Washington DC 20549-1090

**RE: Concept Release on Harmonization of Securities Offering Exemptions  
File No. S7-08-19**

Dear Ms. Countryman:

As the Commission's Investor Advocate,<sup>1</sup> I appreciate the opportunity to comment on the Concept Release on Harmonization of Securities Offering Exemptions, which the Commission issued on June 18, 2019 (the "Concept Release").<sup>2</sup> As you are aware, the Office of the Investor Advocate is responsible for analyzing the potential impact on investors of proposed regulations of the Commission and also identifying areas in which investors would benefit from changes in existing regulations or rules.<sup>3</sup>

The drafters of the Concept Release should be commended for laying out the requirements of the current registration exemptions in such a comprehensive and understandable way. Given the complexity of the exemptive framework and the surge in capital-raising through exempt offerings, I agree that a fresh examination of these exemptions is warranted.

Changes to the exemptions could have major implications for individual investors. The Concept Release touches upon two of these implications—namely, the Commission suggests that investors may benefit from having greater access to exempt offerings, and the Commission requests data regarding the incidence of fraud. These are important considerations, and I

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<sup>1</sup> The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. The views expressed herein are my own and do not reflect those of the Commission, the Commissioners or other members of the staff.

<sup>2</sup> See Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10649 (June 18, 2019) ("Concept Release"), <https://www.sec.gov/rules/concept/2019/33-10649.pdf>.

<sup>3</sup> 15 U.S.C. § 78d(g)(4).

encourage commenters to address these issues.<sup>4</sup> However, in order to fulfill my obligation to analyze the potential impact on investors from changes to the exemptions, I raise some further questions and encourage commenters to include a discussion of these additional issues within their responses to the Concept Release.<sup>5</sup>

## 1. Is there retail investor demand for exempt offerings?

A basic premise of the Concept Release seems to be that existing exemptions may prevent companies from accessing an untapped reservoir of capital. I believe the Commission should analyze whether the easing of regulatory safeguards associated with those exemptions, presumably at the cost of investor protection, would actually result in a countervailing benefit of significant capital formation.

Data from the Federal Reserve Board's Survey of Consumer Finances<sup>6</sup> suggest that companies may not be able to raise a lot of money from retail investors who do not already meet the definition of accredited investor. According to the Survey, the top ten percent of U.S. households by net worth—a segment of the population that would include most accredited investors<sup>7</sup>—hold 77.1 percent of the wealth in this country.<sup>8</sup> When one looks beyond that top decile of households, the likelihood of stock ownership falls off dramatically. Even more remote is the likelihood that a household would have a portfolio of securities that is large enough for a financial professional to reasonably recommend the purchase of securities that are exempt from registration.

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<sup>4</sup> In an authoritative article on the historical need for our mandatory corporate disclosure system, historian Joel Seligman pointedly criticized the Commission for broadening the small-issue exemptions in the 1970s without having studied the incidence of fraud among issuers employing them. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 57-61 (1983) (“To so substantially expand the small business exemptions without publication of any analysis of the problems this may create for investors represents an ignorance of [the] mandate [to protect investors] and of the problems that led to the passage of the 1933 Securities Act.”). In the Concept Release, the Commission again refrains from attempting such a study, this time citing data limitations that make it difficult to draw rigorous conclusions. I encourage other commenters to weigh in with suggestions for overcoming these limitations. Even if statistical rigor is elusive, knowledge gained from systematically reviewing litigated cases of fraud and analyzing their circumstances can yield useful insights.

<sup>5</sup> Although I am empowered to make recommendations to the Commission, this comment letter should not be construed as such (and requiring a formal response pursuant to Section 4(g)(7) of the Exchange Act, 15 U.S.C. § 78d(g)(7)). I may, however, incorporate the ideas expressed herein into a future formal recommendation.

<sup>6</sup> See Board of Governors of the Federal Reserve System, *2016 SCF Chartbook* (“Chartbook”), <https://www.federalreserve.gov/econres/files/BulletinCharts.pdf>. The Commission utilizes this source of data to estimate the number of households that qualify as accredited investors, but the data also provide important information about households that are not accredited.

<sup>7</sup> The Concept Release estimates that 9.4 percent of households would qualify as accredited investors because they have a net worth of \$1,000,000 or more. A total of 13 percent of households would qualify as accredited investors because they would meet either the income or net worth tests set forth within the definition. Concept Release, *supra* note 2, at 36.

<sup>8</sup> Jesse Bricker, et al., Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances* (Sept. 2017) (“Federal Reserve Bulletin”), at 10-11, <https://www.federalreserve.gov/publications/files/scf17.pdf>.

Consider the amount of financial assets—which include all bank accounts, certificates of deposit, cash value life insurance, stocks, bonds, and pooled investment funds (including retirement accounts)<sup>9</sup>—held by households. For the households in the bottom quartile of household net worth, the median value of financial assets held is a mere \$1,000.<sup>10</sup> For the next quartile of households (those between the 25th and 50th percentiles of net worth), the median value of financial assets held is \$10,000.<sup>11</sup> The next quartile up (between the 50th to 75th percentiles) is a bit better off, but the median value of financial assets held is still only \$62,100.<sup>12</sup> For three-fourths of American households, then, it is hard to imagine that there would be a significant demand for the exempt markets.

Of course, the portion of the population lying just below the current accredited investor thresholds—which would likely include households between the 75th and 90th percentiles in terms of net worth—is more likely to have the financial wherewithal to invest in the exempt markets. For these households, the median value of financial assets held is \$283,900.<sup>13</sup> Consider, however, the investment portfolios of these households. For this segment of the population, the median value of retirement accounts is \$198,000, which means that most of these households' financial assets are in retirement accounts.<sup>14</sup> Moreover, as shown below, slightly less than one in four of these households hold stocks directly,<sup>15</sup> and for those that do, the median value of the holdings is approximately \$28,000.<sup>16</sup>

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<sup>9</sup> See Federal Reserve Bulletin, *supra* note 8, at 18.

<sup>10</sup> Chartbook, *supra* note 6, at 145.

<sup>11</sup> *Id.*

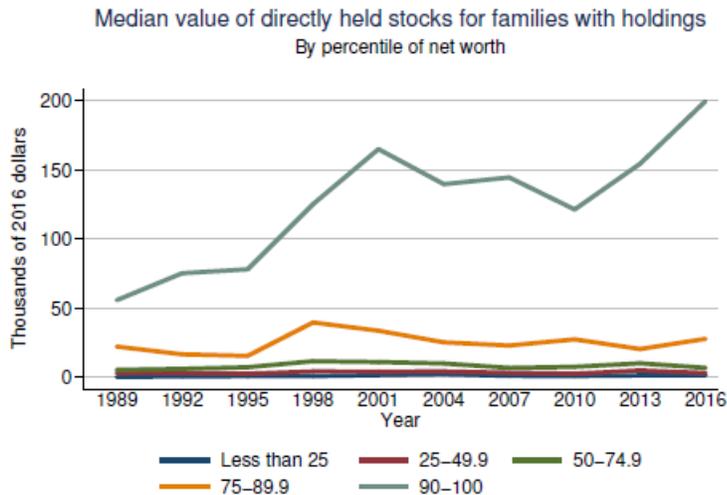
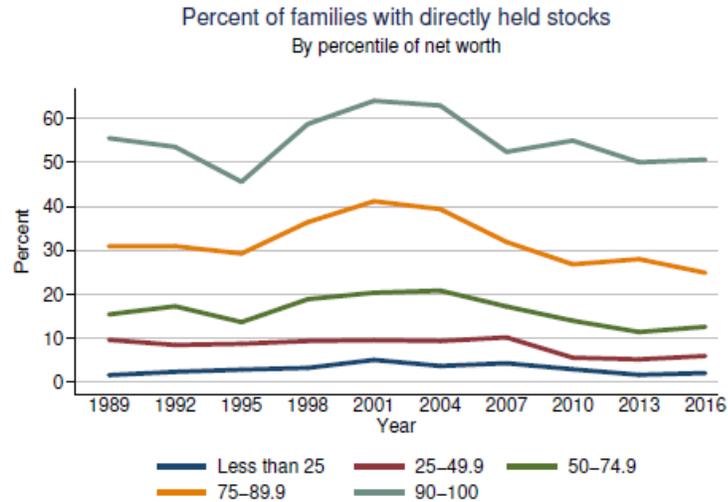
<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 469.

<sup>15</sup> *Id.* at 324.

<sup>16</sup> *Id.* at 325. We note that the Federal Reserve's definition of "directly held stocks" does not include securities held in retirement accounts. If retirement accounts are included, the value of directly held stock is likely to be higher, but the difference is unknown. According to the Center for Retirement Research at Boston College, the typical household approaching retirement age holds nearly all of its financial assets within a 401(k). See Alicia H. Munnell and Anqui Chen, Center for Retirement Research at Boston College, *401(k)/IRA Holdings in 2016: An Update from the SCF* (Oct. 2017), at 6, <https://crr.bc.edu/briefs/401k-ira-holdings-in-2016-an-update-from-the-scf/>. Vanguard, which administers approximately 14 percent of the market for defined contribution plans, reports that only nine percent of firms offer company stock in their plans. *Id.* at 4-5.



If the Commission were to consider making exempt offerings more accessible to non-accredited investors, some important questions should be addressed. For instance, to what extent should the Commission allow these securities to be sold to persons with limited financial assets, or as investments within retirement accounts?<sup>17</sup> And, if non-accredited households are currently investing in stocks at such low rates, is it reasonable to expect that they will have a significant interest in exempt offerings?

The recent experience with Regulation A and Regulation Crowdfunding seems to suggest that retail investor demand for offerings by early stage companies is limited. Both of these exemptions were explicitly designed to allow companies to offer their securities to non-

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<sup>17</sup> See, e.g., SEC, Office of Investor Education and Advocacy, *Investor Alert: Self-Directed IRAs and the Risk of Fraud* (Aug. 8, 2018), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-self-directed-iras-risk-fraud>.

accredited investors. However, according to the Concept Release, only 132 issuers have reported proceeds from a Regulation A offering, and those issuers have raised less than half of the amount sought.<sup>18</sup>

Of the completed offerings under Regulation Crowdfunding, the average amount raised was \$208,300, well below the \$577,385 maximum that was sought in the average offering.<sup>19</sup> Unfortunately, information on the number of investors per offering and the average amounts invested is not available for the full sample of Regulation Crowdfunding offerings.<sup>20</sup> According to a few funding portals, however, average amounts invested were substantially below the existing investment limits.<sup>21</sup> And, according to one of the funding portals, accredited investors accounted for approximately 40 percent of the amounts invested in its offerings.<sup>22</sup>

I encourage commenters to provide other data that would help the Commission evaluate the level of retail investor demand for exempt offerings. In addition, are there certain types of businesses or investments that generate greater investor interest, and could the Commission design exemptions that would accommodate those types of investments?

## 2. Do companies actually want small investors?

Press reports indicate that private equity firms and other institutional investors have a surplus of capital waiting to be deployed.<sup>23</sup> Moreover, according to the staff's Report to the Commission on Regulation Crowdfunding, many issuers have indicated that a large number of investors on an issuer's capitalization table can be unwieldy and potentially impede future financing.<sup>24</sup> Thus, to avoid raising small amounts of capital from a large number of retail investors, issuers are likely to first seek out sophisticated institutional investors who are competing for promising deals.

Given this environment, the Commission should consider the willingness of promising start-ups to attract small-dollar investors and the quality of the offerings that would be made available to them. In reality, the expansion of exempt offerings to non-accredited investors could mean that small-dollar investors are given access only to those exempt offerings that were passed over by sophisticated institutional investors.

I am also concerned that small-dollar investors may be driven into investment structures in which they bear the downside risk of losing their entire principal while their potential for profits is severely restricted. An illustration of this is the introduction of the Simple Agreement

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<sup>18</sup> See Concept Release, *supra* note 2, at 98.

<sup>19</sup> SEC, *Report to the Commission: Regulation Crowdfunding* (June 18, 2019) ("Crowdfunding Report"), at 4, [https://www.sec.gov/files/regulation-crowdfunding-2019\\_0.pdf](https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf).

<sup>20</sup> *Id.* at 38.

<sup>21</sup> *Id.* at 46.

<sup>22</sup> *Id.* at 39.

<sup>23</sup> See, e.g., Julie Segal, "How Dry Powder Could Blow Up Private Credit and Private Equity," Institutional Investor (Mar. 6, 2019), <https://www.institutionalinvestor.com/article/b1df7crzrp8wnq/How-Dry-Powder-Could-Blow-Up-Private-Credit-and-Private-Equity>.

<sup>24</sup> Crowdfunding Report, *supra* note 19, at 58.

for Future Equity (“SAFE”) in the crowdfunding space. In my Office’s Report on Activities for Fiscal Year 2016, we identified SAFEs as one of the most problematic investment products because the features which distinguish it from common stock and make it riskier are often poorly explained.<sup>25</sup> Shortly after we issued our Report on Activities, the SEC issued an investor alert that identified many of the same concerns.<sup>26</sup> Unfortunately, the expansion of exempt offerings to more retail investors could result in the proliferation of similar investment structures.

I encourage commenters to assess whether promising companies are interested in having small investors. In addition, please describe how retail investors are likely to be treated in the private markets if they are given greater access to early-stage investments, and please consider whether it is possible for the Commission to level the playing field between large and small investors.

### **3. What other challenges will small investors confront if they participate in exempt offerings?**

If an investor—large or small—chooses to invest in securities that are not publicly-traded, the investor is likely to encounter some challenges. For example, the offering will be exempt from the disclosure requirements that apply to publicly-traded securities, so the investor is likely to have less information about the company and may encounter informational asymmetries that put the investor at a disadvantage vis-à-vis other investors.<sup>27</sup> The security also will be less liquid, so the investor may not be able to resell the security at the desired time or price.

For a small-dollar investor, the challenges in the exempt markets may be magnified. For example, early-stage companies have a high failure rate, so venture capital and private equity investors tend to diversify their holdings so that a small number of highly successful investments will outweigh the expected losses.<sup>28</sup> Given the demographic statistics noted above, the average American household may find it difficult to appropriately diversify its portfolio so that it has a reasonable chance of success in the exempt markets.<sup>29</sup>

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<sup>25</sup> See SEC, Office of the Investor Advocate, *Report on Activities, Fiscal Year 2016* (Dec. 21, 2016), at 20-21, <https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-on-activities-2016.pdf>.

<sup>26</sup> See SEC, Office of Investor Education and Advocacy, *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding* (May 9, 2017), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_safes](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes).

<sup>27</sup> See also Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 205-221 (Dec. 2012) (describing information issues in the private secondary markets, including lack of information, asymmetric information, conflicts of interest and insider trading).

<sup>28</sup> See generally Steven Overly, “Schools venture into new territory,” *The Washington Post* (Feb. 16, 2015), Rolfe Winkler, “Venture Capitalists Chase Next Tech Wave After Smartphones,” *The Wall Street Journal* (Oct. 24, 2016), and Rolfe Winkler, “Why Goldman and Pritzker Sank Millions into a Startup Before Suing It for Fraud,” *The Wall Street Journal* (Jan. 26, 2018).

<sup>29</sup> The SEC’s Office of Investor Education and Advocacy suggested in a recent Investor Bulletin that, generally, it may be easier to achieve diversification through ownership of mutual funds or exchange-traded funds rather than through ownership of individual stocks or bonds. See SEC, Office of Investor Education and Advocacy, *Investor*

In the exempt markets—particularly in offerings conducted under Rule 506—investors are also expected to protect their own interests. To be successful, then, investors need to have the skills or financial wherewithal to conduct due diligence, and they need to be able to assess the value of a company to ensure that the price of the security is reasonable. For a household with limited financial assets, it may not be cost-effective to commit the time or resources that are necessary to avoid the pitfalls of the exempt markets.

I note that a broker-dealer would be subject to the suitability rule (and new Regulation Best Interest) in making a recommendation to a retail investor regarding the purchase of shares in an exempt offering.<sup>30</sup> Thus, if a broker-dealer encouraged someone of limited means (who lacked the ability to diversify) to purchase shares in a highly risky, illiquid security, the broker-dealer may be liable for making an unsuitable recommendation. The Commission should consider the extent to which the expansion of exemptions would, in effect, grant issuers the ability to sell to retail investors shares that generally would be considered unsuitable if recommended by a broker-dealer.

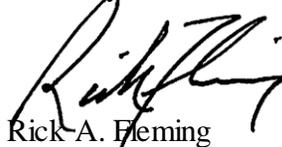
I encourage commenters to discuss the challenges that small investors could face in the exempt markets, including the issues described above and any challenges that have not been identified. Moreover, please consider whether the Commission could address these concerns while giving small-dollar investors greater access to early-stage investments.

## Conclusion

Again, I appreciate the opportunity to submit my observations about the significant implications for investors if changes are made to the Securities Act registration exemptions. I encourage other commenters to address these issues and, in general, to provide the Commission with a more fulsome perspective of investors in the exempt markets. In my view, greater insight into these issues could lead to better policy outcomes.

Should you have any questions, please do not hesitate to contact me or my counsel, Alexandra M. Ledbetter.

Sincerely,



Rick A. Fleming  
Investor Advocate

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*Bulletin: 10 Investment Tips for 2019* (Feb. 12, 2019), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_investmenttips2019](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_investmenttips2019).

<sup>30</sup> See SEC, Office of Investor Education and Advocacy, *Investor Bulletin: Private Placements Under Regulation D* (Sept. 24, 2014), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-private-placements-under>.