Testimony:

Reforming the Definition of Accredited Investor and Business Development Companies

J. Robert Brown, Jr.[1]

The federal securities laws were designed to protect investors by ensuring that they had adequate disclosure whenever an issuer sold securities. The private placement exemption is an exception to this approach. These offerings often involve companies with high risk, little publicly available information, and illiquid trading markets. They frequently fail.[2]

The accredited investor concept seeks to ensure that unregistered investments are sold only to persons who can fend for themselves.[3] The accredited investor standard currently relies on dollar thresholds as an objective substitute for sophistication. Agreement exists that the definition requires reform. The debate is over how to best ensure that the definition covers persons who have the requisite degree of sophistication and excludes those who do not.

With respect to Business Development Companies, these entities play an important role in providing funding to "small growing and financially troubled enterprises."[4] Taking steps to facilitate the ability of BDCs to better provide financing to these enterprises is an important goal. Increasing the leverage limits as proposed in this legislation seems an appropriate method of advancing this goal. Altering the definition of eligible portfolio company, however, raises the risk that this much needed source of funding will be redirected away from operating companies, reducing the capital available to these businesses.

[1] Professor of Law, University of Denver Sturm College of Law; Secretary, Investor Advisory Committee, Securities & Exchange Commission. The IAC has made a recommendation with respect to the definition of accredited investor which I support. Nonetheless, this testimony does reflect my views and does not necessarily reflect the views of the IAC or its members.

[2] *See* Exchange Act Release No. 70741 (Oct. 23, 2013) ("a 2010 study reports that of a random sample of 4,022 new high-technology businesses started in 2004, only 68% survived by the end of 2008. Other studies also have documented high failure rates for small newly listed companies. For example, the ten-year delist rate for newly listed firms during the period 1981-1991 is 44.1%, compared to 16.9% for newly listed firms in the 1970s.").

[3] Securities Act Release No. 6683 (Jan. 16, 1987) ("This concept [of accredited investor] is intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary. ").

[4] Investment Company Act Release No. 12274 (March 5, 1982).

I. Accredited Investors

A. Background

The Commission adopted the test for individuals qualifying as accredited investors in 1982.[5] The rule was an appropriate response to the concerns that existed at the time. Under the reigning case law, private placements were largely limited to sophisticated investors who were deemed not to need the protections of the securities laws.[6] As a judicially developed doctrine, however, sophistication was an amorphous and uncertain concept.[7]

The Commission responded to the concern by opting for an objective standard in determining sophistication. Accredited investors included anyone with a net worth of $1 million or in excess of $200,000 a year in income over a multiple year period. The SEC understood that dollar amounts alone did not always act as an adequate substitute for sophistication. As a result, the amounts were deliberately set at very high levels[8] in an effort to ensure that most investors were likely to be sophisticated or at least wealthy enough to retain the necessary expertise.[9]

When the definition was originally adopted, a second mechanism existed for ensuring that investors purchasing unregistered securities were actually sophisticated. Private placements under Rule 506 could not be sold through general solicitations, largely eliminating indiscriminate marketing efforts. As a result, most investors participating in private placements likely had preexisting relationships with, and were known to, their brokers.[10] Brokers confronting investors

---

[5] Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (Mar. 8, 1982).

[6] *See Securities and Exchange Commission v. Ralston-Purina Co*., 346 U.S. 119 (1953).

[7] *See* Securities Act Release No. 5487 (April 23, 1974) ("The application of these criteria [from Ralston] and other guidelines set forth from time to time by the Commission and the courts has resulted in uncertainty about the availability of the exemption. In addition, some misconceptions have arisen in connection with certain methods used by persons who seek to claim the exemption.").

[8] Thus, rather than determine the appropriateness of particular types of assets included in the test, the Commission actually increased the thresholds from what had been proposed, presumably eliminating the need to make such determinations. *See* Securities Act Release No. 6389 (March 8, 1982) ("Some commentators, however, recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to $1,000,000 without exclusions.").

[9] Approximately 1.8% of families qualified as accredited in 1982. Commissioner Luis A. Aguilar, Revisiting the "Accredited Investor" Definition to Better Protect Investors, US SEC, Dec. 17, 2014, n. 3, *available at* http://www.sec.gov/news/statement/spch121714laa.html#_ednref3 The percentage increase to 7.4% by 2010. *See* Exchange Act Release No. 69959 (July 10, 2013) ("We estimate that at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of 'accredited investor'").

[10] Exchange Act Release No. 69959 (July 10, 2013) ("While we do not know what percentage of investors in Rule 506 offerings are natural persons, the vast majority of Regulation D offerings are conducted without the use of an intermediary, suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation."), *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

who met the dollar thresholds under the definition but in fact were not sophisticated were in a position to moderate their recommendations accordingly.

The dollar thresholds set out in the original rule have largely remained unchanged for more than 30 years.[11] At the same time, however, the financial landscape has undergone a tectonic shift. The markets have grown in complexity. Most significantly, however, has been the shift away from pensions to defined contribution plans. As a result, individuals have needed to assume increased responsibility for managing their retirement nest egg. Defined contribution plans have also provided a massive pool of funds for investment.[12] As one SEC official put it back in 2000, this has caused "a massive movement of middle America into the securities markets".[13]

Likewise, the number of retirees has undergone sustained growth. The oldest members of the Baby Boom generation celebrated their 65th birthday in 2011. Every day thereafter 10,000 baby boomers have reached the age of 65 and will continue to do so until 2030.[14] Many of these older investors are unsophisticated and "lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees."[15]

As retirement funds held by individuals have increasingly become available for investing, the method of marketing private placements has likewise changed. With the end to the prohibition of general solicitations, individual investors can be solicited through indiscriminate forms of mass marketing, including blast emails, ads on the Internet,[16] infomercials on cable television, or seminars offering inducements such as "free" meals.[17] FINRA has issued notices about offers involving "pre-IPO shares,"[18] high yield investment programs,[19] and investment in

---

[11] The thresholds have not changed. The definition with respect to individuals has, however, been amended on several occasions. Most recently, the definition was changed to exclude the value of the primary residence from the calculation of net worth. *See* Securities Act Release No. 9287 (Dec. 21, 2011). The definition was also amended in 1988 to provide that families qualified with an income of $300,000 and to eliminate a test based upon the amount invested. *See* Securities Act Release No. 6758 (March 3, 1988) (eliminating qualification as accredited where investor with $750,000 in net assets purchases at least $150,000 in a single investment).

[12] Assets in defined contribution plans have grown dramatically, going from less than $200 billion in 1980, http://www.ici.org/pdf/per12-02.pdf, to almost $4 trillion in 2014. *See* http://www.americanbenefitscouncil.org/documents2013/401k_stats.pdf

[13] https://www.sec.gov/news/speech/spch369.htm ("In 1980, that number [of American households that invested in a mutual fund] was one out of 18."). The percentage of families with mutual funds today is almost 50%. *See* http://www.ici.org/pdf/per19-09.pdf

[14] http://www.pewresearch.org/daily-number/baby-boomers-retire/

[15] http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part2.pdf

[16] *In re Spectrum Concepts, LLC*, Release No. 770 (admin proc April 7, 2015) (information about an offering allegedly posted "on a classified advertisement website in order to attract investors broadly.").

[17] https://www.finra.org/investors/alerts/free-lunch-investment-seminars%E2%80%94avoiding-heartburn-hard-sell ("In a 2007 report, securities regulators, including FINRA, the U.S. Securities and Exchange Commission, and state regulators, conducted more than 100 examinations involving free-meal seminars. In half the cases, the sales materials—including the invitations and advertisements for the events—contained claims that appeared to be exaggerated, misleading or otherwise unwarranted. And 13 percent of the seminars appeared to involve fraud, ranging from unfounded projections of returns to sales of fictitious products.").

[18] https://www.finra.org/investors/alerts/pre-ipo-offerings%E2%80%94these-scammers-are-not-your-friends ("For instance, in late December 2010, shortly after the Securities and Exchange Commission settled a civil action, federal prosecutors brought criminal charges against a self-employed securities trader who allegedly bilked more than 50 U.S. and foreign investors out of more than $9.6 million in a series of pre-IPO scams spanning an eight-year period.

the marijuana business.[20] The use of general solicitations increases the likelihood that those invited to participate in an unregistered offering will not have a pre-existing relationship with the issuer or broker.[21]

As a practical matter, therefore, private placements are likely to be offered increasingly to investors lacking in adequate sophistication and who have, as a primary source of liquidity, funds in retirement plans. The definition of accredited investor should, therefore, take these altered dynamics into account. The definition should not be written to sweep into the category large swathes of people who in fact are not sophisticated and are not able to adequately assess the risks of the these investments.

B. The Direction of Reform

With respect to reform, there is probably more agreement than disagreement. For one thing, the accredited investor definition never made room for persons who were in fact sophisticated. For another, the dollar thresholds, as currently formulated, are not an adequate guarantee of accredited investor status.[22] There seems to be agreement that, at a minimum, the numerical thresholds were arbitrary when determined[23] and require reexamination.[24]

We were also aware of other potentially fraudulent schemes that solicited potential victims by purporting to sell shares of Facebook."). *See also SEC v. Premier Links*, Inc., Litigation Release No. 23163 (Dec. 19, 2014) (allegations that seniors were "cold-called" and subjected to "high-pressure sales tactics to convince seniors to invest in companies purportedly on the brink of conducting initial public offerings").

[19] https://www.finra.org/investors/alerts/hyips%E2%80%94high-yield-investment-programs-are-hazardous-your-investment-portfolio ("HYIPs use an array of websites and social media—including YouTube, Twitter and Facebook—to lure investors, fabricating a 'buzz' and creating the illusion of social consensus, which is a common persuasion tactic fraudsters use to suggest that 'everyone is investing in HYIPs, so they must be legitimate.'").

[20] http://www.finra.org/investors/alerts/marijuana-stock-scams

[21] Remarks of SEC Commissioner Luis A. Aguilar, "The Importance of Small Business Capital Formation", 33rd Annual SEC Government-Business Forum on Small Business Capital Formation, Nov. 20, 2014, Washington, DC, *available at* http://www.sec.gov/info/smallbus/gbfor33.pdf ("In addition, the definition of 'accredited investor' has taken on greater meaning now that issuers can engage, without registration, in unlimited advertising and solicitation, so long as the ultimate purchasers are accredited investors. Given the importance of this definition in helping to identify investors that are presumably sophisticated and financially able to invest in illiquid securities, the accredited investor definition is particularly important.").

[22] Recommendation of the SEC's Investor Advisory Committee: Accredited Investor Definition, Oct. 9, 2014 ("IAC Recommendation"), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf ("the current definition of net worth does not guarantee that the individual accredited investor will in fact have sufficient liquid financial assets to ensure either that they can hold the securities indefinitely or that they can withstand a significant loss on those investments.").

[23] *See* Speech by Michael S. Piwowar, *Capital Unbound*, Remarks at the Cato Summit on Financial Regulation, NY NY, June 2, 2015 ("As the Commission's Investor Advisory Committee has pointed out, simply adjusting the tests for inflation may not be the right answer. We do not know, for instance, if the levels set in 1982 were right to begin with. Were they too high or too low? Further, a single national threshold might be both under-inclusive and over-inclusive at the same time: earning $200,000 a year in rural Iowa is quite different than making $200,000 here in New York City.").

[24] The GAO Report on the definition of accredited investor showed a division among those responding on whether the dollar thresholds should be increased. *See Alternative Criteria for Qualifying As An Accredited Investor Should be Considered*, GAO Report No. 13-640, July 2013. Objections to an increase often focused on the perceived impact on the total pool of investors. Id. at 17. This may, however, be mitigated to the extent that the definition is

A strong starting place for any reforms should be the recommendations made by the SEC's Investor Advisory Committee with respect to the definition of accredited investor.[25] These include:

Recommendation 1. The Commission should carefully evaluate whether the accredited investor definition, as it pertains to natural persons, is effective in identifying a class of individuals who do not need the protections afforded by the '33 Act. If, as the Committee expects, a closer analysis reveals that a significant percentage of individuals who currently qualify as accredited investors are not in fact capable of protecting their own interests, the Commission should promptly initiate rulemaking to revise the definition to better achieve its intended goal.

The Supporting Rationale for the recommendation discussed categories of investors who meet the income and net worth thresholds but arguably do not qualify as sophisticated. Nonetheless, this does not necessarily mean that the appropriate fix is to simply adjust the thresholds for inflation. As the supporting statement noted:

> we do not know with any certainty whether the Commission found exactly the right level when it set those thresholds originally. It is equally possible that they were set either too low or too high to provide the needed investor protections. Moreover, the investing population has changed significantly since that time, with a larger percentage of unsophisticated, middle income individuals turning to the securities markets to save for retirement today than did so 30 years ago. The complexity of financial products, including financial products sold through private offerings, has also grown in the intervening years. Thus, thresholds that made sense for the investing population of 1982 may or may not make sense in 2014.

The analysis suggested consideration of alternative approaches that looked to the types of assets included in the determination. In particular, the Supporting Rationale noted that "there may be certain types of financial assets, such as retirement accounts, that should not be included in the calculation."

Recommendation 2. The Commission should revise the definition to enable individuals to qualify as accredited investors based on their financial sophistication.

The Supporting Statement acknowledged three mechanisms for establishing sophistication -- professional credentials, investment experience, and a test of relevant financial knowledge. Credentials that might qualify included the series 7 securities license. Experience might include acting as a professional in the financial industry or private equity sector for a

---

simultaneously changed to permit investors to qualify as accredited on the basis of actual sophistication, including experience.

[25] IAC Recommendation, *supra* note 22 ("The Committee does not believe that the current definition as it pertains to natural persons effectively serves this function in all instances. ").

specified period or actual investment experience. Finally, testing would need to be sufficiently rigorous to "indicate a reasonable level of relevant financial expertise."

Recommendation 3. If the Commission chooses to continue with an approach that relies exclusively or mainly on financial thresholds, the Commission should consider alternative approaches to setting such thresholds – in particular limiting investments in private offerings to a percentage of assets or income – which could better protect investors without unnecessarily shrinking the pool of accredited investors.

As the Supporting Rationale notes, the current definition is essentially an "on/off switch." Once an investor qualifies as accredited, there are no limits on the amount that can be invested. On possible approach, therefore, might be to limit the amount of investment as a percentage of income or assets. The restrictions could be reduced or eliminated as assets and income increase.

Recommendation 4. The Commission should take concrete steps to encourage development of an alternative means of verifying accredited investor status that shifts the burden away from issuers who may, in some cases, be poorly equipped to conduct that verification, particularly if the accredited investor definition is made more complex.

Recommendation 5. In addition to any changes to the accredited investor standard, the Commission should 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. Specifically, the Committee recommends that in such circumstances the Commission prohibit individuals who are acting as purchaser representatives in a professional capacity from having any personal financial stake in the investment being recommended, prohibit such purchaser representatives from accepting direct or indirect compensation or payment from the issuer, and require purchaser representatives who are compensated by the purchaser to accept a fiduciary duty to act in the best interests of the purchaser.

* * *

These recommendations suggest that the definition should be reconsidered holistically and not in a piecemeal fashion. Moreover, the holistic approach is more likely to result in an outcome that ensures a definition that excludes investors who continue to need the protections of the securities laws and ensures that issuers have a greater ability to engage in cost effective offerings in reliance on the private placement exemption.

C. HR 2187

HR 2187 seeks to address some but not all of the current concerns that exist under the accredited definition standard. Significantly, the draft legislation would extend the definition of accredited investor to persons who have no demonstrated capacity to absorb the loss should any particular investment fail. As a result, even greater care should be taken to ensure that an approach based upon education, experience and testing but without reliance on financial thresholds does not accidentally sweep into the definition persons who are in fact not sophisticated.

1. Automatic Accredited Investor Status

The legislation seeks to provide automatic accredited investor status to any person described in paragraphs (1), (2), (3), or (4) of section 506(c)(2)(ii)(C), irrespective of the income and net worth requirements. The provision specifically lists:

(*1*) A registered broker-dealer;

(*2*) An investment adviser registered with the Securities and Exchange Commission;

(*3*) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or

(*4*) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.[26]

To the extent that the provision is intended to extend accredited investor status to registered representatives employed by brokers,[27] these individuals generally must pass a Series 7 exam issued by FINRA and therefore have some knowledge and background on investments.[28] They also have continuing education requirements.[29]

To the extent that the provision is intended to extend accredited investor status to investment adviser representatives,[30] these individuals generally must have completed a Series 65 exam.[31] As a result, they also generally have some knowledge and background on

[26] Rule 506(c)(2)(ii)(C), 17 CFR 230.506(c)(2)(ii)(C).
[27] The bill currently references registered broker-dealers. Rule 501(a)(1) extends the definition of accredited investor to "any broker or dealer registered pursuant to Section 15" of the Exchange Act. 17 CFR 230.501(a)(1).
[28] http://www.finra.org/sites/default/files/Series_7_Study_Outline.pdf
[29] For brokers, see FINRA Rule 1250, Continuing Education Requirements, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10204
[30] With respect to investment advisers, firms may sometimes register with the SEC but their representatives do not. *See* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf ("Although many individuals who are employed by advisers fall within the definition of 'investment adviser,' the SEC generally does not require those individuals to register as advisers with the SEC. Instead, the advisory firm must register with the SEC.").
[31] The exam is the responsibility of NASAA but administered by FINRA. *See* http://www.finra.org/industry/series65 For an outline of the content of the exam, see http://www.nasaa.org/wp-content/uploads/2011/08/Series-65-Exam-Specification.pdf

investments. They are not, as a result of registration, generally subject to continuing education requirements.[32]

In contrast, the 1,266,158 active lawyers do not possess sufficient indicia of sophistication either through education or experience.[33] There is nothing inherent in a legal education that ensures lawyers will be sophisticated with respect to investments in unregistered securities. Courses at law schools that might provide meaningful understanding of investments such as Corporate Finance are not typically required.[34] Moreover, even courses such as those providing background on the federal securities laws, including the exemptions from registration, typically emphasize legal compliance and do emphasize the types of investments available in the market or their level of risk. Nor do lawyers necessarily obtain that expertise as a result of their practice area.[35] The likelihood that this change will sweep into the definition of accredited a large number of investors who in fact are not sophisticated is very high.[36]

Finally, the legislation may have unintended harmful consequences. The legislation leaves out other categories of persons likely to be sophisticated. It does not take into account persons who are sophisticated as a result of relevant education or actual experience. To the extent that this legislation was adopted, the incentive by regulators to revise the definition in other ways would be overtaken by the need to implement the legislation.

2. Self-Certification

HR 2187 provides that these four categories of persons will be treated as accredited "if such person certifies to the issuer prior to the sale of securities" that he or she fits within one of the aforementioned categories.

---

[32] http://www.nasaa.org/industry-resources/exams/exam-faqs/#25 ("There are no continuing education requirements for NASAA exams at the present time."). The exam only needs to be retaken if there is a two year lapse in association with a registered investment adviser. *See* http://www.nasaa.org/industry-resources/exams/exam-faqs/ ("When an individual first passes an exam, that person has two years to become licensed (registered) with a state or the exam expires. Once registered, the exam remains valid as long as the person stays registered. When a registered person's job is terminated (usually reflected by the filing of a Form U5 by the employer), the state registration terminates as well. The individual then has two years to be re-employed and re-registered or the exam will be shown as "expired" in the Central Registration Depository (CRD).").

[33] https://lawschooltuitionbubble.wordpress.com/original-research-updated/lawyers-per-capita-by-state/

[34] http://www.americanbar.org/content/dam/aba/publications/misc/legal_education/2012_survey_of_law_school_curricula_2002_2010_executive_summary.authcheckdam.pdf ("The number of law schools that required courses beyond the first year has remained relatively constant since 2002, with Constitutional Law and Evidence garnering the most support as required upper division doctrinal courses. For the first time, 28% of law school respondents indicated that they required a specific upper division legal writing course.").

[35] For a demographic break down of lawyers and their employment, see http://www.americanbar.org/content/dam/aba/migrated/marketresearch/PublicDocuments/lawyer_demographics_2012_revised.authcheckdam.pdf

[36] The inclusion of lawyers and CPAs into Rule 506 (c)(2)(ii)(C) was unrelated to investment acumen. They were deemed appropriate categories of persons to verify accredited investor status. The Commission was not concerned with their knowledge of investments but their professional competence and ethical standards. *See* Exchange Act Release No. 9415 (July 10, 2014) ("in the United States, attorneys and certified public accountants are licensed at the state level and are subject to rules of professional conduct"). Verifying the amount of income or the value of assets is very different than understanding the risks associated with an unregistered security.

The language suggests that issuers will only need to obtain the requisite certification without having to undertake additional verification. To the extent true, the language arguably overturns the provision in the JOBS Act that requires issuers to take "reasonable steps" to ensure accredited investor status.

Nor does self-certification ensure that investors are in fact registered representatives, investment adviser representatives, lawyers, or CPAs. There are a number of reasons why individuals might incorrectly certify their status. They may be mistaken about their current status. Investors may misrepresent their status in order to participate in what looks like an attractive offer. [37] They may also do so at the instigation of a third party [38] or as a result of fabrication by a third party.[39]

It should also be noted that at least for some of the categories referenced in the legislation, verification is not difficult. The status of registered representatives and investment adviser representatives can be easily ascertained in existing and accessible data bases.[40]

3. Retention and Use of Services

HR 2187 would also permit persons to certify that they have retained a broker, adviser, attorney or CPA and "used the services . . . to make an investment decision relative to the securities being offered". This provision allows unsophisticated investors to qualify as accredited simply by retaining a professional and using the professional's services in connection with the investment. The language, however, raises a number of concerns.

First, the language of the provision is unclear. It does not explicitly provide that the professional must have been retained to provide investment advice with respect to a particular security. A lawyer providing estate planning or a CPA reviewing a tax return could provide "services" related to an investment without actually providing investment advice.

---

[37] *See* Markup of H.R. 2940, Access to Capital for Job Creators Act, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee, 112th Cong. (Oct. 5, 2011) (remarks of Representative Waters) (Nov. 3, 2011) ("there will be no reason to believe that any investor seduced by public advertising will hesitate to be dishonest with completing the investor suitability questionnaire").

[38] *See In re Sabado*, Securities Act Release No. 9238 (July 14, 2011) (allegations broker "instructed" investor to represent himself as accredited "when he was not.")

[39] *See In re Bettiga*, Securities Act Release No. 7553 (admin proc. July 9, 1998) (allegations subscription agreements falsified "in order to qualify [investors] as accredited investors by adding a fictitious asset to their financial information."); *In re Kaechelle*, Securities Act Release No. 7148 (March 8, 1995) (allegations that employee "permitted . . . salesmen and other employees to fabricate investor accreditation information"); *In re Henry*, Exchange Act Release No. 40183 (admin proc July 9, 1998) (allegations that by "falsifying the customers 'net worth' on these documents, the two registered representatives . . . qualified non-accredited investors as accredited investors."); *In re Dominion Capital Corp*., Securities Act Release No. 7683 (admin proc May 13, 1999) (allegations that "representatives submitted false, inflated statements of customers' net worth on new account forms and subscription agreements . . . in order to qualify numerous customers to purchase these LLC interests. ").

[40] For a discussion of these data bases, see https://www.sec.gov/spotlight/investor-advisory-committee-2012/backgroundcheck-recommendation-april2-2015final.pdf

Second, the provision does not include a requirement that the professionals have any particular understanding or knowledge with respect to the investment at issue.

Third, the provision does not include any disqualifications for market professionals who have been determined to be bad actors.[41]

Fourth, the provision relies on self-certification by the investor. As discussed above, such information may be inaccurate. Moreover, an investor may not have been correctly informed as to the status of the person offering the financial product.[42]

Fifth, under the language, customers of brokers and advisers may become accredited simply as a result of receipt of investment recommendations. This would arguably be the case even where the broker or adviser knew that the investor lacked the sophistication needed to understand the investment.

Sixth, the provision does not include any prophylactic safeguards designed to ensure that investors are adequately protected in their relationship with the relevant professional. The definition of Purchaser Representative in Rule 501 requires that the representative have sufficient knowledge and experience about the prospective investment. There must be a written acknowledgement of a representative's status. Purchaser representatives must disclose certain conflicts of interest. None of these safeguards are required in the current draft.

Finally, the categories included in the legislation provide investors with different types of duties. Brokers, for example, are subject to suitability requirements while advisers have fiduciary duties. In the context of the sale of unregistered shares, individuals obtaining accredited status solely as a result of a recommendation from a retained market professional should receive a consistent and high standard of care. Such professionals should, therefore, be subject to a uniform fiduciary obligation.

4. Testing

HR 2187 would require the SEC to establish criteria for the use by FINRA "in administering an exam to license as accredited investors natural persons who don't meet the income and net worth requirements". The criteria "may include methods for assuring that

[41] *See* Rule 506(d), 17 CFR 230.506(d) (defining bad actor standards).

[42] *SEC v. Dodge*, Litigation Release No. 21759 (WD TX Dec. 1, 2010) (allegations in the complaint that individual "misrepresented that he was a licensed securities broker and that he had verified the validity of the Private Placement program."); *SEC v. Clifford*, Litigation Release No. 20622 (D. Mass. June 18, 2008) (allegations in the complaint that individual misrepresented that he was a "registered investment advisor[]" and was "affiliated with a particular registered investment adviser/broker-dealer when he was not"); *In re Robert A. Tommassello*, Exchange Act Release No. 51587 (admin proc. April 21, 2005) (allegations that individual "misrepresented to investors [that corporation was] a registered investment adviser.'"). *See also* https://www.finra.org/investors/alerts/cold-calls-brokerage-firm-imposters%E2%80%94beware-old-fashioned-phishing ("Recently, FINRA has received reports that scamsters are posing as employees of at least one well-known brokerage firm to obtain personal information. In a new twist to Internet "phishing schemes," which use spam email to lure you into revealing everything from Social Security numbers to financial account information, it appears that some fraudsters may be resorting to a time-tested method—the telephone call.").

licensed accredited investors demonstrate a competency in understanding" including the following:

A. The different types of securities.
B. The disclosure obligations under the securities laws of issuers versus private companies.
C. The structures of corporate governance.
D. The components of a financial statement.
E. Other criteria the Commission shall establish in the public interest and for the protection of investors.

Testing is an appropriate method of determining sophistication. The test needs to be thorough and robust and administered by the proper agency or entity.[43] It also needs to have a temporal component that requires retesting or at least additional testing after a defined period of time. An investor who passes the test at age 25 may not have an adequate understanding of the risks associate with the market 50 years later.

The list of tested factors should also be expanded. Other possible topics include: (1) market structure, such as the role of brokers, advisers and other financial professionals (2) the principal factors affecting securities markets and prices, whether bonds or equities; (3) an understanding of primary and secondary offerings, including restrictions on resales and consequences of illiquidity; (4) the traditional risk profile for particular types off investors, particularly those with retirement plans and other tax advantaged accounts; (5) an understanding of collective investment vehicles such as closed end funds, real estate investment trusts, hedge funds, and, blind pool/ blank check companies; and (6) the common factors that suggest a heightened risk of securities fraud.

D. The Ongoing Process

As required by Section 413 of Dodd-Frank,[44] the staff at the Commission is working on a study of the definition of accredited investor with respect to individuals with the goal of determining whether adjustments should be made.[45] Changes must be "appropriate for the protection of investors, in the public interest, and in light of the economy." Commentators have had a chance to weigh in the process and provide their views.[46]

The staff likely has under review all aspects of the definition, including both the dollar thresholds and the need to add categories of individuals who are sophisticated in fact. The SEC

[43] FINRA has experience administering tests to market professionals rather than investors.
[44] *See* Net Worth Standard for Accredited Investors, Securities Act Rel. No. 9287, at 5-6 (Dec. 21, 20 II) ("Section 413(b) specifically authorizes us to undertake a review of the definition of the term 'accredited investor' as it applies to natural persons, and requires us to undertake a review of the definition in its entirety every four years, beginning four years after enactment of the Dodd-Frank Act. We are also authorized to engage in rulemaking to make adjustments to the definition after each such review."), *available at* http://www.sec.gov/rules/final/2011/33-9287.pdf
[45] Speech by Commissioner Piwowar, supra ("I welcome this review, and am pleased that staff in our Division of Corporation Finance is currently working on the study.")
[46] *See* http://www.sec.gov/comments/jobs-title-iv/jobs-title-iv.shtml; *see also* https://www.sec.gov/comments/s7-06-13/s70613.shtml

is, therefore, in a position to engage in a holistic, thoughtful reevaluation of the definition that takes in to account all of the competing interests. The results will presumably be made public and presumably generate proposals for reform of the accredited investor definition. Any legislative revisions should be delayed at least until the completion of this process.

II. Business Development Companies

Business development companies were created to "make capital more readily available to small developing and financially troubled businesses."[47] To accomplish this task, BDCs can only invest 70% of total assets in securities of certain types of companies ("eligible portfolio companies"). Excluded from this definition are investment companies and companies set out in Section 3(c) of the 1940 Act.[48]

Among other things, proposed revisions would reduce the asset coverage for senior securities representing indebtedness from 200% to 150%, permit multiple classes of preferred shares, and alter the definition of eligible portfolio company to permit an increase in investments in non-operating companies. Finally, discussion has occurred over the authority of commercial banks to sponsor BDCs under the Volcker Rule.[49]

Some of the proposed revisions, such as the reduction in the asset coverage for senior securities, appear to be appropriate reforms designed to allow BDCs to have some additional capacity to raise funds. Such a change will potentially increase the risks associated with a BDC. Nonetheless, this is one area where adequate disclosure to investors appears to be a reasonable method of addressing the concern. In addition, the draft legislative proposal provides investors with an opportunity to exit the company before the new limits become applicable.

The draft legislative proposal would also allow for the issuance of multiple classes of preferred shares. In doing so, the proposal would eliminate a number of investor protections currently in the statute. These include the right of preferred shares to elect at least two directors or, in some cases, the entire board. Likewise, the legislation would eliminate the right of shareholders to approve a reorganization that adversely affected such securities. The provision also provides that preferred shares need not have voting rights or equal voting rights.

The elimination of these protections is ameliorated by a provision in the current draft that provides that changes shall not apply to stock "issued to a person who is not known by the company to be a qualified institutional buyer". The provision therefore ensures that only very sophisticated purchasers will acquires these shares from the BDC. It should be noted, however,

---

[47] Investment Company Act Release No. 27538 (Oct. 25, 2006).

[48] Section 2(a)(46) of the Investment Company Act of 1940; *see also* Section 3(c) of the Investment Company Act of 1940.

[49] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5675 (Jan. 31, 2014) ("The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which are regulated by the SEC as investment companies.").

that the provision appears to be limited to shares issued by the BDC and does not appear to apply to resales.

The provision does, however, provide discretion that at least in some cases can disadvantage the common stockholders. By eliminating the need for voting rights or "equal voting rights with every other outstanding voting stock" the provision does not prohibit super-voting shares (shares with more than one vote per share).[50] A BDC could conceivably issue a new class of preferred shares that transfers voting control to the owners of that class. Moreover, new classes or series of preferred shares can typically be issued by the board of directors, without shareholder approval.[51] Perhaps the provision could be changed to provide that the provisions of Section 18(i) of the 1940 Act would only be inapplicable with respect to voting rights to the extent that voting rights are equal to or less than the voting rights of the common shares.

Perhaps the most serious concern posed by this draft legislation is the proposed change in the definition of eligible portfolio company. The legislation would allow BDCs to increase the percentage of assets that can be invested in financial firms. When adopted in 1980, Congress deliberately sought to increase funding to operating companies rather than financial firms.[52] The purpose was to protect a class of companies considered critical to the US economy. As the House Report stated:

> The Committee is well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years. The importance of these businesses to the American economic system in terms of innovation, productivity, increased competition and the jobs they create is, of course, critical. Hence, the need to reverse this downward trend is of compelling public concern.

H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20 (1980). Congress sought to provide assistance both by increasing the amount of capital available to eligible operating companies and by requiring that the BDCs offer them "significant managerial assistance."[53]

Changing the definition of eligible portfolio company to permit increased investment in financial firms may result in a reduction in the funds available to operating companies. It may also result in an increase in the cost of funds to operating companies. To the extent that

---

[50] Section 18(i) of the 1940 Act.

[51] The authority to do so is commonly found in the articles. For an example of this authority, see *GOLDMAN SACHS BDC, INC.*, Article IV, Certificate of Incorporation, *available at* http://www.sec.gov/Archives/edgar/data/1572694/000119312515074210/d838148dex99a.htm

[52] *See* Small Business Investment Incentive Act of 1980, HR Rep. No. 96-1341, 96th Congress, 2d Sess. 29 ("This requirement ensures that the business development company will invest in operating companies rather than investing in other financial institutions. For example, an eligible portfolio company could not be a broker, bank or insurance company."); *see also id*. at 61 ("Unlike most registered investment companies, business development companies frequently have control of the operating companies in which they invest. This section makes clear that control, in and of itself, does not serve to bring those operating companies within the purview of the Investment Company Act.").

[53] 15 USC 80a-2(a)(47). This can include any arrangement whereby the BDC provides "significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company". *Id*.

operating companies incur a reduction in financing from BDCs, they will also not benefit from the obligation to provide significant managerial assistance.

With respect to the decision by commercial banks to form BDCs, this has the capacity to impact the market occupied by BDCs. Even with a limit in the number of shares that a commercial bank is likely to own,[54] the market may perceive the credit of a bank sponsored BDC as superior to at least some of the other BDCs, perhaps even as implicitly guaranteed. Any funding advantage could, as a result, allow bank sponsored BDCs to increase their market share.[55]

[54] To avoid treating the BDC as an affiliate, banks may not "own, control, or hold with the power to vote 25 percent or more of the voting shares" of a BDC. *See* 12 CFR §248.12(b) Permitted investment in a covered fund

[55] For an article addressing the competitive advantages of commercial banks in other contexts, see J. Robert Brown, Jr., *The "Great Fall": The Consequences of Repealing the Glass-Steagall Act*, 2 Stanford J. L., Bus. & Fin. 129 (1995), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=961634