



22 West Washington Street
Chicago
Illinois 60602

Telephone: +1 312 696-6000
Facsimile: +1 312 696-6001

June 1, 2020

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Release Nos. 33–10763; 34–88321; File No. S7–05–20, RIN 3235–AM27,
Proposed Rule: Facilitating Capital Formation and Expanding Investment Opportunities
by Improving Access to Capital in Private Markets

Ladies and Gentlemen:

Thank you for the opportunity to share our views on the Proposed Rule: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (Proposed Rule).¹

Morningstar brings several unique perspectives to the questions in the Proposed Rule. Through our PitchBook subsidiary, we track data on nearly 14,000 private equity funds, along with other private funds and investment opportunities, spanning venture capital, real estate, private debt, and mergers and acquisitions, and are also users of the data available on Forms C and D. Additionally, as the world’s largest provider of mutual fund data and ratings, Morningstar has a long history of advocating for transparency in global financial markets. Morningstar’s mission is to empower investor success.

In this letter, we comment on three areas of the proposal. First, as the Commission is making changes to Regulation D offering requirements, we think it is also appropriate to make changes to Form D. Second, we appreciate the Commission’s objective of ensuring that providing certain information about companies and “testing the waters” regarding offerings should not constitute an offering, but we seek a clarification regarding information provided to third parties conducting independent analysis. Third, we have concerns regarding the changes to the requirements around crowdfunding, in particular, and think the Commission should not open up crowdfunding to the degree it proposes. The high emotions and volatile public market caused by the social and economic dislocations of living through a pandemic could make crowdfunding more attractive to ordinary individuals, making it all the more vital to maintain investor protections.

¹ Securities and Exchange Commission. 2020. “Proposed Rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets.” <https://www.federalregister.gov/documents/2020/03/31/2020-04799/facilitating-capital-formation-and-expanding-investment-opportunities-by-improving-access-to-capital> (Proposed Rule)

Disclosure Requirements Should Be Enhanced If Access to Private Investments Increases

As we said previously in our response to the Concept Release on Harmonization of Securities Offering Exemptions,² information on Form D is of a limited nature.³ Private investments are inherently more unregulated and have fewer disclosure requirements than registered funds and public companies. In Morningstar's experience through our subsidiary, PitchBook, information obtained through Form D is usually incomplete and inconsistently provided. If such offerings were to be made more broadly available, however, the Commission would have to balance the need for better information against the cost of providing the information for private market participants.

Morningstar believes that the current Form D requirements could be expanded to better serve investors should private offerings become more widely accessible. We believe the SEC should consider changing its requirements relating to when Form D is amended. Currently, Form D does not have to be amended in certain situations.⁴ We believe that the following currently exempt events should trigger an amendment: (i) "the total offering amount, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice, does not result in an increase of more than 10%;" (ii) "the amount of securities sold in the offering or the amount remaining to be sold;" and (iii) "the minimum investment amount, if the change is an increase, or if the change, together with all other changes in that amount since the previously filed notice, does not result in a decrease of more than 10%."⁵

In Morningstar's experience with the PitchBook business, the lack of data on items (i) and (ii) makes it impossible to know the ultimate size of an investment opportunity. Companies are not required to notify the Commission or the public when the value of a company's equity offering is different than anticipated. It is important for investors to know what investing opportunities are available. Even though the offering amount in item (i) has changed by less than 10%, we think this change is material for investors. It is also important for companies to be aware of the availability of private capital. Thus, more information on this front would further the SEC's mission of facilitating capital formation.

² Securities and Exchange Commission. 2019. "Concept Release on Harmonization of Securities Offerings Exemptions." <https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf>.

³ Sethi, J., & Szapiro, A. 2019. "Comment Letter on File Number S7-08-19, RIN 3235-AM27, Concept Release on Harmonization of Securities Offering Exemptions." Morningstar. <https://www.sec.gov/comments/s7-08-19/s70819-6167324-192371.pdf>.

⁴ Securities and Exchange Commission. 2017. "Filing and Amending a Form D Notice: A Compliance Guide for Small Entities and Others." <https://www.sec.gov/info/smallbus/secg/formdguide.htm>.

⁵ Securities and Exchange Commission. P. D 5. Form D. <https://www.sec.gov/about/forms/formd.pdf>.

Changes in the minimum investment amount described in item (iii) are also important for investors. This item provides investors more information about the demand for a particular investment opportunity. Making these events trigger an amendment, and not all the items on the form, strikes an appropriate balance between providing more information to the market and imposing regulatory costs.

Providing Information to Third Parties Conducting Independent Analysis Should Not Constitute an Offering

We appreciate the Commission’s objective to exempt “demo days” and similar events from general solicitation through a “tailored approach” that offers investor protection while affording issuers, particularly small and emerging ones, and investors “the opportunity to more efficiently expand and grow their networks.”⁶ We support this objective, and our work through PitchBook provides investors with independent analysis of investment opportunities. PitchBook collects information from more than 2.6 million public and private companies (including startups, private equity-backed, and venture-capital-backed companies)⁷ at different stages of their funding life cycles—sometimes when they are in the process of seeking funding and sometimes before or after a funding round. As such, information provided to PitchBook could be simultaneous with other communications to “test the waters” or simply provide information to investors attending a demo day or other event. We ask the Commission to clarify that information provided to third parties conducting independent analysis does not constitute an offering, even if it is passed along to investors. The purpose of data collection by PitchBook is research and providing information to investors—not soliciting investing.

The Expansion of Crowdfunding is Unnecessary and Presents Unique Risks in the Current Market Environment

We appreciate the Commission’s objective to make private opportunities more available to investors. As such, the Commission has recently proposed amending the definition of accredited investors.⁸ Any change to the definition of accredited investor will have an impact on the changes to the crowdfunding rules the Commission is proposing. Given the interaction between the accredited investor definition and the Proposed Rule, we encourage the Commission to solicit comments on the definition of accredited investor and the crowdfunding rules in conjunction with each other before adoption.

⁶ Proposed Rule, P. 17975.

⁷ PitchBook. “Our Global Data: Companies.” <https://pitchbook.com/platform-data/companies>.

⁸ Securities and Exchange Commission. 2020. “Proposed Rule on Amending the ‘Accredited Investor’ Definition.” <https://www.govinfo.gov/content/pkg/FR-2020-01-15/pdf/2019-28304.pdf> (Amending the Accredited Investor Definition).

We have several concerns regarding the Commission’s proposed changes to the crowdfunding rules. First, we do not see evidence that a problem exists to be solved. As the Commission estimated in its June 2019 Regulation Crowdfunding report, only “29 offerings reported raising at least \$1.07 million from May 16, 2016 through December 31, 2018”⁹ out of an estimated 1,351 offerings (excluding those withdrawn),¹⁰ yielding only 2% of offerings that might benefit from the increased threshold. In addition, only three issuers were found to have reported raising more than \$1.07 million over that period through multiple offerings.¹¹ Consequently, we do not see any need for the increase in the limit for one offering to \$5 million.¹²

Second, we think the Commission should proceed cautiously with loosening restrictions, particularly at this time when market volatility makes net worth more volatile and crowdfunding may be an appealing route for some companies struggling with funding in the current economic environment. To illustrate our concerns, the table below shows with illustrative examples how the SEC’s proposal would impact different groups of investors.

Group	Investment Limit Under Current Crowdfunding Rule	Investment Limit Under the SEC’s Proposal ¹³
Group A: Investors With Annual Income or Net Worth <\$107,000	the greater of \$2,200 or 5% of the lesser of the investor’s annual income or net worth	the greater of \$2,200 or 5% of the greater of the investor’s annual income or net worth
<i>Ex: Annual income of \$100,000 and net worth of \$50,000</i>	\$2,500	\$5,000
Group B: Nonaccredited Investors With Annual Income and Net Worth ≥\$107,000	the lesser of 10% of the investor’s annual income or net worth	the greater of 10% of the investor’s annual income or net worth
<i>Ex: Annual income of \$150,000 and net worth of \$110,000</i>	\$11,000	\$15,000
Group C: Accredited Investors	the lesser of 10% of the investor’s annual income or net worth	no limit

⁹ Securities and Exchange Commission. 2019. “Report to the Commission, Regulation Crowdfunding.” P. 15. https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf (Crowdfunding Report)

¹⁰ Crowdfunding Report, P. 14.

¹¹ Crowdfunding Report, P. 15.

¹² Proposed Rule, 17 CFR Sec. 227.100(a)(1), P. 18039.

¹³ Proposed Rule, 17 CFR Sec. 227.100(a)(2)(i)-(ii), P. 18040.

As the table shows, the example individual in Group A would be able to invest twice as much under the SEC's proposal than under current regulations. The example individual in Group B would be able to invest over 33% more under the SEC's proposal than under current regulations. We note that net worth for most individuals likely represents the value of a 401(k) balance minus nonmortgage debt, such as credit card debt. We could be supportive of loosening restrictions if net worth accounted for whether the individual had reasonable retirement security. Net worth only excludes the primary residence, which does not account for the financial well-being of renters and improperly assumes that a house is more necessary than a diversified retirement portfolio in determining an individual's ability to take on investment risk.

We are very concerned about the increased equity crowdfunding allowances being made to Groups A and B and believe that the Commission should proceed cautiously in loosening restrictions, particularly as it is in the process of expanding the universe of accredited investors. We believe that the Commission should not loosen the restrictions on Group A and should consider adding some additional requirements on Group B. We think that any loosening on Group B individuals should be accompanied by some additional standards, such as excluding retirement savings up to a threshold level, consulting with a financial adviser, or demonstrating some knowledge of investing and risks associated with equity crowdfunding, akin to what the SEC is considering in its efforts to change the definition of accredited investors.¹⁴ If individuals in Group B demonstrate the knowledge, as defined by the Commission, to be accredited investors, or go through a financial advisor, or their net worth excludes at least some of their savings in retirement accounts, we believe such an investor is in a much better position to place a significant bet on one company through crowdfunding. Barring any of these changes, we think the current allowance under the Proposed Rule could open investors to significant losses of capital that could otherwise be earning a steady return in a retirement account.

We are not concerned with the lack of a limit on Group C individuals under the current definition of accredited investor because these investors have access to such opportunities through various means today. We encourage the Commission, however, to allow for comments on these regulations in conjunction with the definition of accredited investor it plans to adopt.

Our concern for Groups A and B stems from several realities. First, no source of investment advice exists for individuals investing in crowdfunded companies. Intermediaries provide sparse advice, conduct limited due diligence, and provide merely boilerplate risk warnings. Individuals are unlikely to obtain the type of investment advice on a crowdfunding opportunity that they might get from a broker or investment advisor on a public stock, fund, or annuity. Indeed, even an investor who sought such advice would likely have difficulty finding someone qualified to give them such advice, as these advisors tend to work with angel investors and private institutions.

¹⁴ Amending the Accredited Investor Definition.

For nonaccredited investors, scams may be harder to detect. For instance, the SEC filed a fraud case against Ascenergy, an oil-and-gas start-up, saying that its founder funneled most of what he raised on equity crowdfunding sites to himself or other businesses he owned.¹⁵ Similarly, SeedInvest founder Ryan Feit turned away dozens of companies that wanted to raise money from investors on his site “that had clear red flags” only to find they had successfully landed on other crowdfunding portals.¹⁶

Second, no adequate explanation of how crowdfunding should be part of a larger diversified portfolio is required on intermediary platforms. For instance, GeeFunding features bare language: “Diversification is an essential part of investing. Investors should only invest a proportion of their available investment funds via GeeFunding portal and should balance this with safer, more liquid investments.”¹⁷ Sophisticated investors advocate investing in angel funds or a diversified portfolio, not one company.¹⁸ By analyzing the performance of limited partner investors, AngelList found that investors who treat early-stage venture capital as an asset class, and invest systematically into it, tend to do much better than investors who select only a few deals.¹⁹ Investments in more companies tend to generate higher investment returns. On average, median returns per year increase 9.0 basis points and mean returns per year increase 6.9 basis points for each additional company to which a limited partner is exposed.²⁰ Individuals in Group A definitely do not have the means to diversify across companies, and those in Group B are also significantly limited in their ability to diversify and gain access to financial advice regarding crowdfunding opportunities.

Third, the coronavirus pandemic is also associated with an uptick in crowdfunding, a potentially worrying trend.²¹ Richard Swart, chief strategy officer at NextGen, explained that connectedness rather than money is often a motivation for investing: “the social logic to regulated crowdfunding is that you care about the company doing it.”²² While such a motivation is charitable, it does not provide any standard for how an

¹⁵ Deutsch, W. 2018. “Equity Crowdfunding Is Inflating a Bubble.” Chicago Booth Review. <https://review.chicagobooth.edu/entrepreneurship/2018/article/equity-crowdfunding-inflating-bubble> (Equity Crowdfunding Is Inflating a Bubble)

¹⁶ Wile, R. 2017. “Can you get rich by investing in a startup? How to do it—and the pros and cons of crowdfunding.” CNBC. <https://www.cnbc.com/2017/07/05/can-you-get-rich-by-investing-in-a-startup-how-to-do-it--and-the-pros-and-cons-of-crowdfunding.html> (Can You Get Rich)

¹⁷ Gee Funding, Inc. “Risk Warning.” <https://geefunding.com/content/pages/risk-warning>.

¹⁸ Koh, N., & Othman, A. 2020. “How Portfolio Size Affects Early-Stage Venture Returns.” AngelList. P. 2. <https://angel.co/pdf/lp-performance.pdf> (AngelList)

¹⁹ Ibid.

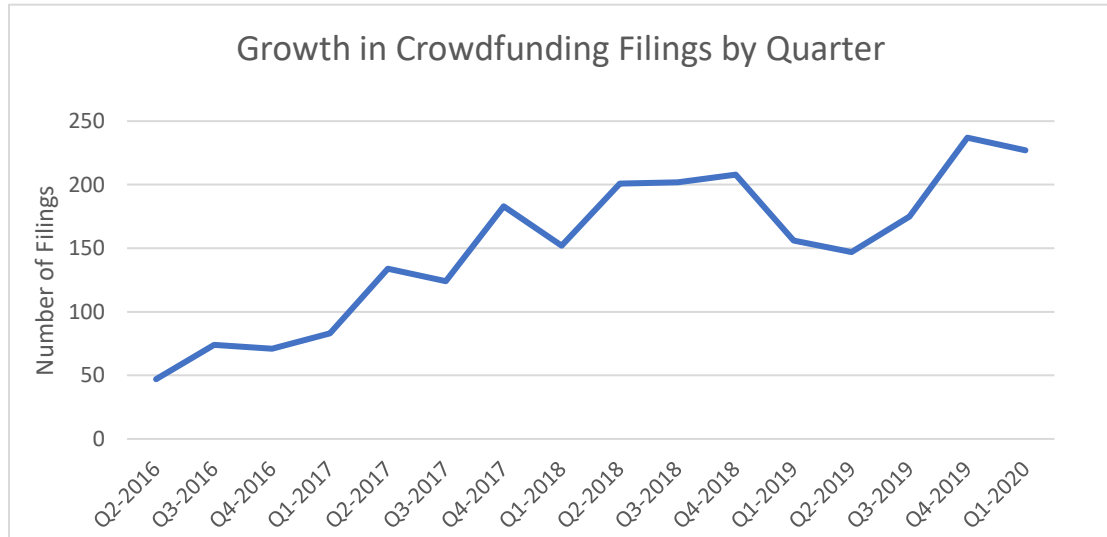
²⁰ AngelList, P. 1.

²¹ Alois, J.D. 2020. “While Most Markets Struggle, Reg CF Shows Resilience in Early Days of COVID-19 Pandemic.” Crowdfund Insider.

<https://www.crowdfundinsider.com/2020/03/159100-while-most-markets-struggle-reg-cf-shows-resilience-in-early-days-of-covid-19-pandemic/> (While Most Markets Struggle)

²² Can You Get Rich.

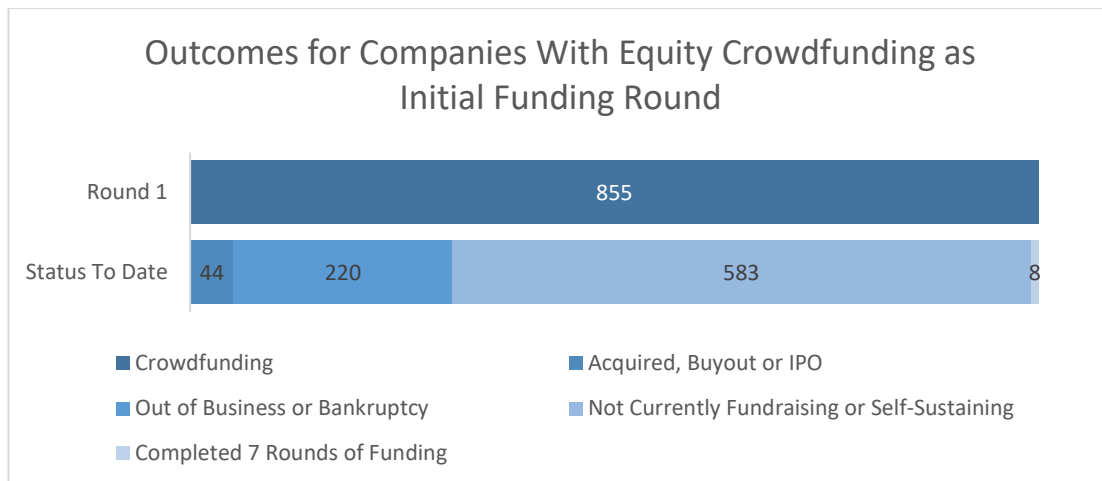
investment should be part of a diversified portfolio intended for retirement or other long-term needs.



Data from SEC Crowdfunding Offering Data Sets (<https://www.sec.gov/dera/data/crowdfunding-offerings-data-sets>) as of May 2020 as analyzed by Morningstar.

As illustrated in the chart above, while the number of filings submitted in the first half of 2019 dipped below 2018 numbers, the fourth quarter of 2019 and first quarter of 2020 saw record numbers of crowdfunding opportunities come to market, with more than 220 Form C filings submitted in each quarter. Even in normal times, crowdfunding is very risky. About half of new businesses do not make it to their fourth year.²³ Of the 855 companies PitchBook tracks that had an initial round consisting of equity crowdfunding, 220 companies (just over 25%) went out of business or filed for bankruptcy. Company outcomes can be seen in the bar graph below.

²³ Bahney, A. 2016. "How to Launch A Small Business: 5 Secrets to a Successful Startup Company." Mic. <https://www.mic.com/articles/159770/how-to-launch-a-small-business-secrets-to-a-successful-startup-company#.oh9pkkJKU>.



Data from PitchBook as of May 21, 2020. Includes companies that PitchBook tracks and which identified equity crowdfunding as their first round of funding since 2014.

An economy growing at 2%-4% annually cannot absorb all the new companies created every year,²⁴ let alone one hindered by the current pandemic environment.

In the current environment, when emotions run high and the public markets are volatile, crowdfunding could become increasingly common, making it even more vital to maintain investor protections. For all these reasons we believe this is not the time to be permitting more significant investments by individuals in Group A, particularly when the demand and need has not been shown. Further, we think that some additional restriction should apply to Group B investors, either deriving from how the Commission will define accredited investors or by protecting retirement assets. We support the Commission's permitting accredited investors to have no limits based on the current definition of accredited investors, as these individuals have access to private investment opportunities through other means, so limiting them vis-à-vis crowdfunding does not serve a policy objective. We do encourage the Commission to solicit comment on the accredited investor definition it plans to adopt in conjunction with the crowdfunding rules as a significant expansion of the accredited investor definition would impact our concerns regarding Group C, particularly for individuals near retirement age whose wealth is primarily held in their retirement accounts.

Conclusion

In summary, we believe the Commission should accompany changes to Regulation D offerings with commensurate improvements to Form D. We support the Commission's objective to allow more information to reach investors and the public at large without such information constituting an offering and seek clarification that information given to third-party research providers does not constitute an offering. We urge the Commission to either not loosen its crowdfunding limits at this time or include some

²⁴ Equity Crowdfunding Is Inflating a Bubble.

additional safeguards given the lack of a need for such a change, the lack of advice available on crowdfunding opportunities, and the risks it presents, particularly during the current crisis.

We thank the Commission for the opportunity to comment on the Proposed Rule. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact any of us as indicated below:

Aron Szapiro at aron.szapiro@morningstar.com or (312) 696-6074.
Jasmin Sethi at jasmin.sethi@morningstar.com or (617) 501-5446.

Sincerely,

Aron Szapiro
Head of Policy Research, Morningstar, Inc.

Jasmin Sethi
Associate Director of Policy Research, Morningstar, Inc.