May 27, 2020

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC
20549-1090

Re: File Number S1-08-19

Dear Ms. Countryman:

Scopus Financial Group, a leading provider of regulatory services, submits this letter in response to the Commission's request for comments on its "Concept Release on Harmonization of Securities Offering Exemptions." We are submitting this letter after the comment period has closed in order to attach my pertinent, recently published law review article. Scopus respectfully requests that the Commission include this comment letter in the public file.

On page 30486 the Commission asked:

> Should [the Commission] consider eliminating or scaling the information requirements depending on the characteristics of the non-accredited investors participating in the offering, such as if all non-accredited investors are advised by a financial professional or a purchaser representative?

The Virginia Law & Business Review recently published the attached article entitled, *Protecting Retail Investors: A New Exemption for Private Securities Offerings,* in which I recommend an exemption to better protect investors.

My proposed exemption would permit any investor, whether or not accredited, to purchase a private offering if the investor retained a purchaser representative who is a registered broker-dealer or investment adviser required to act in the investor's best interest. Issuers to non-accredited investors would be relieved of unnecessary regulatory burdens, such as an evaluation of investor knowledge and experience, unnecessary disclosure, and a limitation of the number of non-accredited investors. Reducing these burdens could open new investment opportunities for retail investors while strengthening their legal protection.

As always, we are available to answer any questions that the Commission or its staff may have.

Sincerely,

/s/ Thomas M. Selman

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VIRGINIA LAW & BUSINESS REVIEW

VOLUME 14 | FALL 2019 | NUMBER 1

PROTECTING RETAIL INVESTORS: A NEW EXEMPTION FOR PRIVATE SECURITIES OFFERINGS

Thomas M. Selman†

ABSTRACT

The Securities and Exchange Commission ("SEC" or "Commission") has embarked upon a comprehensive review of the framework for the exemption of securities offerings from the Securities Act of 1933 ("Securities Act"). The author proposes that the SEC open private placements to more retail investors, while better protecting them from hucksters and scammers.

Many have questioned whether the wealth tests in Rule 506 ensure that "accredited investors" are sophisticated.[1] *Fewer commentators have*

† Executive Vice President of Regulatory Policy and the Legal Compliance Officer for the Financial Industry Regulatory Authority ("FINRA"). The views expressed are those of the author and do not reflect the opinions of FINRA or his FINRA colleagues, many of whom would fervently endorse this disclaimer. The author appreciates the provocative commentary of Robert L.D. Colby, Marcia E. Asquith, Joseph E. Price and Gerri Walsh.

1 *See* SEC Regulation D, 17 C.F.R. § 230.506(c)(2)(ii)(A)-(B) (2019); *see, e.g.*, Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733 (2009); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994); Syed Haq, *Revisiting the Accredited Investor Standard*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 59 (2015); Gregg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285 (2012); *see also* Barbara Roper (@BarbaraRoper1), TWITTER (Sept. 26, 2019, 4:06 AM), https://twitter.com/BarbaraRoper1/status/1177177566907486208 ("A majority of accredited investors aren't financially sophisticated, aren't wealthy enough to take on risks of private offerings, and don't have access to info on private securities to make an informed investment choice. But sure, let's double down on that.").

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written about the Rule 506 exemption for non-accredited investors.[2] *Issuers to non-accredited investors must comply with modest principles, but the non-accredited investor must otherwise fend for himself or receive assistance from a "purchaser representative" upon whom the rule imposes no obligation. This article recommends an exemption to better protect both accredited and non-accredited investors. Any investor, whether or not accredited, would be permitted to purchase a private offering if he or she has retained a purchaser representative who is a registered broker-dealer or investment adviser required to act in the investor's best interest. Issuers to non-accredited investors would also be relieved of unnecessary regulatory burdens, such as requirements that the issuer appraise investor knowledge and experience, make disclosures to the investor and limit the number of non-accredited investors. Reducing these burdens could open new investment opportunities for retail investors while strengthening their legal protection.*

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[2] *See* 17 C.F.R. § 230.506(c)(2)(ii)(A)-(B).

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> *[T]here will nearly always be possibilities of increasing the output obtained from the available resources by investing some of them for longer periods.*[3]

I. INTRODUCTION

THE efficient investment of capital fosters economic growth. Capital formation, the accumulation of capital by growing companies, is an engine of the American economy. A primary purpose of the federal securities laws is to ensure that companies can accumulate and efficiently allocate capital.[4] The securities laws protect investors by deterring fraud, requiring reliable market information, fostering trustworthiness among intermediaries and protecting market integrity. The securities laws also promote investor confidence in the integrity of the capital markets and enable market participants to more efficiently invest in them. Nevertheless, unwise or anachronistic securities regulation can impede capital formation. In recent years, the federal government has liberalized some restrictions on the ability of start-ups to raise capital. For example, on April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS Act") "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[5]

In June 2019, the SEC issued its "Concept Release on Harmonization of Securities Offering Exemptions" ("Concept Release")[6], which solicited public comment regarding "whether our exempt offering framework, as a whole, is consistent, accessible, and effective for both issuers and investors or whether [the SEC] should consider changes to simplify, improve, or harmonize the exempt offering framework."[7] Specifically, the Commission is seeking to "identify gaps [in the exemptive framework] that may make it difficult, especially for smaller issuers, to rely on an exemption from registration to raise capital at key stages of their business cycle."[8] Moreover, the Commission is considering whether "the limitations on who can invest in certain exempt

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3 FRIEDRICH A. HAYEK, THE PURE THEORY OF CAPITAL 60 (1941).

4 *See, e.g.*, Securities Act of 1933 (Securities Act) § 2(b), 15 U.S.C. § 77b(b) (2018).

5 Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 pmbl. (2012).

6 Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10,649, Exchange Act Release No. 86,129, Investment Company Act Release No. 33,512, 84 Fed. Reg. 30,460 (June 26, 2019) [hereinafter Concept Release].

7 *Id.* at 30,461.

8 *Id.*

offerings, or the amount they can invest, provide an appropriate level of investor protection."[9]

Two exemptions for private offerings, Section 4(a)(2) of the Securities Act[10] and Rule 506[11], have been instrumental to the growth of private securities markets. Each will be subject to the SEC's review following public comment. One facet of Rule 506, the exemption for private offerings to "accredited investors,"[12] is the most widely used exemption for private offerings, and has inspired much commentary. Many commentators have questioned the efficacy of the "accredited investor" definition,[13] and one can expect that the SEC will pay particular attention to this part of Rule 506.

This article proposes a novel adjustment that would apply to both accredited and non-accredited investors. Commentators tend to ignore the part of Rule 506 that applies to non-accredited investors because it is less popular among issuers. Nevertheless, it holds a seed for fruitful inquiry; the "purchaser representative" provision.[14] Among the private offerings permitted by Rule 506 are those to the non-accredited investor who has retained a "purchaser representative."[15] To qualify under this rule, the issuer must have reason to believe that the purchaser representative is knowledgeable and experienced and must provide certain disclosures to the investor.[16] However, the exemption imposes no duty or regulatory obligation on the purchaser representative.[17]

The SEC should animate the concept of the purchaser representative by requiring that the purchaser representative be registered under federal law, subject to a best interest standard, and by permitting all investors, including those who are now "accredited," to purchase an offering that the purchaser representative recommends. By doing so, the SEC would better protect investors and could shift regulatory burdens from the private issuer to the purchaser representative.

Thus, any investor, accredited or non-accredited, would be permitted to purchase a private offering if he or she has retained a purchaser representative

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9 *Id.*

10 *See* 15 U.S.C. § 77d(a)(2) (2018). This article will refer to Section 4(a)(2) of the Securities Act even when describing historical events that occurred when this provision had a different numerical designation.

11 *See generally* 17 C.F.R. § 230.506 (2019).

12 *See id.* § 230.506(b)(2)(ii).

13 *See supra* note 1.

14 *See* 17 C.F.R. § 230.506(b)(2)(ii).

15 *See id.*

16 *See id.*

17 *See id.* Although a note in Rule 501 implies that the purchaser representative must act in the investor's interest, it imposes no direct obligation on the purchaser representative to do so and does not elaborate on this implied responsibility. *See* SEC Regulation D, 17 C.F.R. § 230.501 n.3 (2019).

who is a registered broker-dealer or an investment adviser, required to act in the investor's best interest.[18] The SEC could then relieve issuers of unnecessary burdens, such as the requirements that the issuer appraise investor knowledge and experience, make disclosures to the investor and limit the number of investors. The issuer would be expected to verify that the purchaser representative has registered as an investment adviser or broker-dealer, which is a simpler test than the verification of the investor or purchaser representative's knowledge and experience.

Part II explains the private offering exemption in Section 4(a)(2) and the many points of confusion created by its judicial interpretation. Part III explains Rule 506 and describes features that are similarly vague and impractical. Part IV proposes the new exemption and discusses how it might fit into the exemptive framework. Part V discusses the effects of noncompliance with the proposed exemption. Part VI discusses how the proposed exemption could justify a reduction in the issuer's regulatory burdens. Part VII asks whether the proposed exemption should supplement or replace existing exemptions.

II. SECTION 4(A)(2)[19]

Section 5 of the Securities Act requires the registration of publicly offered securities.[20] Section 10 generally requires a prospectus be provided to public investors.[21] This disclosure requirement militates against the potential loss that

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18 The Concept Release requested information concerning whether "the availability of any exemptions be conditioned on the involvement of a registered intermediary, . . . particularly where the offering is open to retail investors who may not currently qualify as accredited investors[.]" Concept Release, *supra* note 6, at 30,469. In 2019, the United States Department of Treasury also recommended that the "accredited investor" definition be broadened to include investors who are advised by a fiduciary. *Id.* at 30,479. Similarly, the Concept Release asked whether the SEC should "permit an investor, whether a natural person or an entity, that is advised by a registered financial professional to be considered an accredited investor[.]" *Id.* at 30,478.

19 Much of this section comes from an article previously written by the author. *See* Thomas M. Selman, *Sidestepping the Rat Holes: Investment Risk and Securities Law*, 8 HARV. BUS. L. REV. 39–40 (2018).

20 *See* 15 U.S.C. § 77e (2018).

21 *See* 15 U.S.C. § 77j (2018). Rule 15c2-8(b) of the Securities Exchange Act of 1934 ("Exchange Act") requires that an underwriter or selling group member, in an initial public offering, deliver a preliminary prospectus to a customer at least 48 hours before sending the confirmation. *See* 17 C.F.R. § 240.15c2-8(b) (2019). Section 5(b)(1) of the Securities Act, as well as Rule 172, require that a final prospectus for any offering be filed with the SEC or delivered to the customer at or before delivery of the confirmation of sale. *See* 15 U.S.C. § 77e(b)(1); SEC Regulation A-R, 17 C.F.R. § 230.172 (2019). Rule 173 requires an underwriter or dealer to provide each purchaser either with a copy of the final prospectus, or a notice that the sale was made under a registration statement or in a transaction in which delivery of the prospectus would have been required if not for Rule 172. *See* SEC Regulation

comes from investing in the dark, i.e., from ignorance about the proposed investment. Prospectus disclosure addresses what one might call "business and market risks," i.e., the risks associated with the issuer's business prospects and its operations,[22] the risks associated with the terms of the security and the possibility that those terms will not be enforceable,[23] the risks associated with the conditions under which the security trades,[24] and the risks associated with economic or political influences on the expected total return.[25] For example, Form S-1, a form commonly used to register publicly offered securities, requires line item disclosure about the offered securities and their market, the risk factors associated with the offering, and the issuer, including its business and securities market.[26] Public disclosure also allows capital markets to reflect

A-R, 17 C.F.R. § 230.173 (2019). Rule 15c2-8(h) of the Exchange Act requires that a managing underwriter for a public offering take reasonable steps to ensure that selling group members receive reasonable quantities of the final prospectus, apparently to ensure that they can comply with the final prospectus delivery requirement. *See* 17 C.F.R. § 240.15c2-8(h).

[22] *See id.* at 40. In analyzing the issuer's business prospects, the investor or purchaser representative might consider such questions as the degree of competition the issuer faces, the absence of barriers to entry, the possibility that customer demand will fall due to substitutes, competing products or loss of interest in the product itself, the negotiating power of its suppliers, the possibility that its input costs will increase, the negotiating power of its distributors and the possibility that its distribution costs will increase. The risks associated with its operations include the risks of technological problems, human error, natural disasters and terrorism.

[23] *See id.* If the security is common stock that pays dividends, what is the risk that future dividends will be reduced or eliminated? If the security is preferred stock, what are the terms governing liquidation or other preferences? If the security is a fixed income security, where does it reside in the issuer's corporate structure? Is it callable? Has the issuer established a sinking fund? If the security is an investment company security, will the investment company be equipped to meet the terms of the security, such as redemption requirements under different market conditions?

[24] *See id.* How liquid will the security be under various market conditions? What is the quality of price discovery in the principal markets on which the security trades? Is the security's price susceptible to the whims of market sentiment because of the issuer's reputation, or because market participants have assigned the security to a particular investment category or index?

[25] *See id.* at n.16. For example, what is the relationship of the expected total return to expected prevailing interest rates, inflation rates, currency valuations, economic output or industrial production? What are the risks associated with unexpected changes in the applicable tax laws, or the political environment in which the issuer operates?

[26] In particular, Form S-1 requires the following line item disclosure:
Item 1/Item 9 – Description of the securities, including their market.
Item 3 – Disclosure of risk factors, including the lack of operating history, the financial position, the business or proposed business and the lack of a market.
Item 11 – Information concerning the registrant, including a description of its business and the securities market, financial information, management's discussion and analysis concerning the "financial condition, changes in financial condition and results of

this information in the price of widely-traded securities and to price the "risk premium" associated with the security. Under Section 11 of the Securities Act, statutory underwriters are strictly liable for false or misleading statements in the registration statement unless they can establish that they conducted due diligence with respect to the disclosure provided.[27]

Section 4(a)(2) of the Securities Act provides an exemption from the registration requirements for "transactions by an issuer not involving any public offering."[28] However, the statute does not define this phrase. In a landmark case, *SEC v. Ralston Purina*, the Supreme Court confronted "an apparent need to define the scope of the private offering exemption."[29] Ralston Purina offered Treasury stock to its "key employees," without registration under the Securities Act.[30] The company did not solicit sales and conceded that an offering to all of its employees would be public.[31] Nevertheless, its definition of "key employee" included employees with the following duties: artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer and veterinarian.[32]

The Court rejected the Commission's argument that "an offering to a substantial number of the public" is not exempt, noting that "the statute would seem to apply to a 'public offering' whether to few or many."[33] Instead, the

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operations," and quantitative information about market risk. SEC. & EXCH. COMM'N, FORM S-1, REGISTRATION STATEMENT UNDER SECURITIES ACT OF 1933 (2019), https://www.sec.gov/files/forms-1.pdf.

27 *See* 15 U.S.C. § 77k (2018); *cf.* Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959) ("The imposition of absolute liability for failure to register nonexempt transactions [under Section 12] was intended to ensure the full and truthful disclosure of all pertinent facts to undisclosed and unidentified prospective purchasers, and to leave the fraud remedies . . . to the more intimate and isolated transactions involving known or identifiable prospective purchasers.").

28 15 U.S.C. § 77d(a)(2) (2018).

29 SEC v. Ralston Purina Co., 346 U.S. 119, 120 (1953).

30 *Id.* at 120.

31 *See id.* at 121–22.

32 *See id.* at 121.

33 *Id.* at 125. Courts have been split on the question of whether the number of investors should be considered in determining whether an offering qualifies as "private." *Cf.* G. Eugene Eng. Found. v. First Fed. Corp., 663 F.2d 988, 990 (10th Cir. 1973) (finding the exemption unavailable in a sale to one investor); United States v. Custer Channel Wing Corp., 376 F.2d 675, 679 (4th Cir. 1967) (denying the contention that the number of investors must be considered); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 467 (2d Cir. 1959) (stating that "the *Ralston Purina* case clearly rejected a quantity limit on the construction of the statutory term").

The *Ralston Purina* Court relied on the absence of "practical need" (in the words of the legislative history) for its conclusion that an offering to investors who are able to fend for themselves is not a public offering. *See Ralston Purina*, 346 U.S. at 119; H.R. REP. NO. 73-85,

Court held that the application of the exemption "turns on whether the particular class of persons affected needs the protection of the [Securities] Act."[34] An offering is "'not involving any public offering' under Section [4(a)(2)] if it is made to those who are able to fend for themselves."[35] The Court held that the exemption was not available to the offerings by Ralston Purina because employees were not shown to "have access to the kind of information which registration would disclose."[36]

Ralston Purina has undeniable appeal. If the registration of publicly offered securities and prospectus disclosure help the investor address business and market risks, and investors otherwise have access to the necessary information and are able to "fend for themselves" in addressing those business and market risks, then registration and prospectus disclosure should be unnecessary. The problem with the decision is not the policy, but its expression. It presents a host of interpretive difficulties that have confounded courts and practitioners who must hammer out its multifaceted implications. Which offerees and investors are able to "fend for themselves?" What constitutes sufficient "access" and disclosure?

It is important to emphasize that an issuer who incorrectly answers these questions might forfeit its exemption. The burden to demonstrate the availability of the exemption is on the issuer.[37] The failure to meet its requirements could result in civil liability, including rescissionary damages.[38] This "put" option incentivizes disappointed investors to sue the issuer, claiming that the exemption was unavailable.[39]

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at 5 (1933). The legislative history also justifies a private offering exemption because "the public benefits [of registration] are too remote." H.R. REP. NO. 73-85, at 5. This justification arguably would be present when the offering is particularly small, regardless of whether the investors had access to information. *See* H. David Heumann, *Is SEC Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings?*, 55 NEB. L. REV. 1 n.2 (1975); Stanley Schwartz, Jr., *Rule 146: The Private Offering Exemption – Historical Perspective and Analysis*, 35 OHIO STATE L.J. 738, 742–43 (1974); *cf.* H.R. REP. NO. 73-152, at 25 (1933) ("Sales of stock to stockholders become subject to the [Securities Act] unless the stockholders are so small in number that the sale to them does not constitute a public offering.").

34 *Ralston Purina*, 346 U.S. at 125.

35 *Id.*

36 *Id.* at 127.

37 *See* Heumann, *supra* note 33, at 4 ("From a practical standpoint, all issuers should be greatly concerned about the potentially immense civil liabilities which might confront them if an after-the-fact decision is made that the section 4(2) exemption does not apply to an offering they effected. More specifically, section 12(1) of the 1933 Act provides a private right of action to any purchaser of an unregistered, non-exempt security. The issuer's only defense is that an exemption from registration applies. Thus, if an issuer mistakenly sells to even one buyer not meeting the standards of sophistication, etc., the entire exemption could be lost.").

38 *See id.*

39 *See id.* at 4–5.

III. RULE 506

Ralston Purina described broad principles for the private placement exemption but the terms that the Court used remained ambiguous. As former SEC Chairman, William Casey, said in 1972, "[f]or 40 years there has been great uncertainty as to what constitutes a private offering."[40] Recognizing the need for more specific guidance, the SEC established a safe harbor in Rule 146 and its successor, Rule 506.[41]

Rule 506, which the SEC promulgated under Regulation D, provides a non-exclusive safe harbor from the registration of private offerings under Section 4(a)(2).[42] Rule 506 permits the sale of privately placed securities to no more than 35 non-accredited investors and to an unlimited number of accredited investors.[43] For purposes of applying Rule 506, Rule 501 defines "accredited investor" for natural persons according to net worth and income tests.[44] As one wag wrote, "Rule 506 . . . departs from the *Ralston Purina* line of cases. Whereas before, private placement purchasers had to be smart, now they need only be rich."[45]

Non-accredited investors must receive disclosure that is generally the same as that used in Regulation A or registered offerings,[46] and each non-accredited investor "either alone or with his purchaser representative(s)" must have:

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40 *Id.* at 3 (quoting Gregory Dubois Erwin, *Goodbye Private Placement, Hello 146 – Recent Appellate Court Decisions Suggest that Investment Bankers Should No Longer Rely on the Private Placement Exemption*, 6 CREIGHTON L. REV. 127 (1972)).

41 *See* 17 C.F.R. § 230.506 (2019). In adopting Rule 146, the SEC hoped that the rule would "reduce uncertainty to the extent feasible and provide more objective standards upon which responsible businessmen may rely in raising capital in a manner that complies with the requirements of the Act." Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 33,5487, 39 Fed. Reg. 15,261, 15,262 (May 2, 1974).

42 *See* 17 C.F.R. § 230.506(a). Other similar exemptions under the Securities Act include Section 4(a)(5), Rule 215 and Rule 504. *See* 15 U.S.C. § 77d(a)(5) (2018); SEC Rule 215, 17 C.F.R. § 230.215 (2019); SEC Regulation D, 17 C.F.R. § 230.504 (2019).

43 *See* 17 C.F.R. § 230.506(b).

44 "Accredited investor" includes any natural person whose individual net worth, or joint net worth with a spouse, exceeds $1,000,000, or who had income in excess of $200,000 in each of the two most recent years, or joint income with a spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year. SEC Regulation D, 17 C.F.R. § 230.501(a)(5)-(6) (2019).

45 C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1123 (1988).

46 *See* Concept Release, *supra* note 6, at 30,466–67; *see also* SEC Regulation D, 17 C.F.R. § 230.502(b) (2019); SEC Regulation A, 17 C.F.R. § 230.252 (2019) (offering statements). A note to Rule 502(b) states that when an issuer provides information under that paragraph, it should consider providing it to accredited investors too, in light of the antifraud provisions of the federal securities laws. *See id.* note.

> Such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.[47]

Purchaser representatives may be, but are not required to be, broker-dealers and investment advisers.[48]

A. The Accredited Investor Standard[49]

The vast majority of Rule 506 offerings are made to accredited investors,[50] who are held to possess the financial sophistication and ability to sustain the

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[47] 17 C.F.R. § 230.506(b)(2)(ii). "Purchaser representative" is similarly defined to include any person who "has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment." 17 C.F.R. § 230.501(i)(2).

[48] *See* 17 C.F.R. § 230.501 n.1 ("A person acting as purchaser representative should consider the applicability of the registration and antifraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 . . . and relating to investment advisers under the Investment Advisers Act of 1940.").

[49] The accredited investor standard is one of many examples of rules attempting to qualify investors for purposes of an exemption from the federal securities laws. *See, e.g.*, Investment Advisers Act of 1940 (Investment Advisers Act), 17 C.F.R. § 275.205-3(d)(1) (2019) (defining "qualified client"); Investment Company Act of 1940 (Investment Company Act) § 2(a)(51)(A), 15 U.S.C. § 80a-2 (2018) (defining "qualified purchaser"); Investment Company Act, 17 C.F.R. § 270.3c-5(a)(4) (2019) (defining "knowledgeable employee"); Exchange Act § 3(a)(54), 15 U.S.C. § 78c(a)(54) (2018) (defining "qualified investor").

[50] *See* Concept Release, *supra* note 6, at 30,484 ("[N]on-accredited investors were reported as participating in only approximately 6% of Rule 506(b) offerings in each of 2015, 2016, 2017, and 2018 . . . ."); *see also* Proposed Revision of Certain Exemptions from the Registration Provisions, Securities Act Release No. 33,6339, 46 Fed. Reg. 41,791, 41,797 (Aug. 18, 1981) ("Based on the experience of its membership, the National Venture Capital Association . . . stated that non-accredited investors are often excluded in private financing due to the costs associated with the delivery of a disclosure document."). In its 2003 study of the hedge fund industry, the SEC staff stated that "[t]he safe harbor most often relied upon by hedge funds under Rule 506 exempts offerings that are made exclusively to 'accredited investors.'" SEC, STAFF REPORT ON THE IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 14 (Sep. 2003), https://www.sec.gov/news/studies/hedgefunds0903.pdf; *see also* Jacob Preiserowicz, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 815 (2006) ("[F]rom a practical standpoint, while [hedge] funds can accept some unaccredited investors, very few do so. They are most likely not investing a considerable amount (otherwise they would most likely fall within the accredited class). Thus, the expense and time that is required to generate the additional material required essentially makes it highly unlikely that the fund will accept these

risk of loss for an investment, or the ability to fend for themselves.[51] However, one cannot assume that accredited investors are financially sophisticated.[52] As the SEC staff has noted:

> Bright lines . . . are necessarily under- and over-inclusive. For example, the fact that an individual has a high net worth does not necessarily mean the individual is financially sophisticated, while a personal finance expert without requisite levels of income or net worth is not an accredited investor under the current definition.[53]

Thus, the SEC staff has recommended that the Commission "review the accredited investor definition to allow individuals to qualify as accredited investors based on other measures of sophistication."[54] Similarly, many

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investors."); Matthew W. Bower, *Reasons to Include Only Accredited Investors in Your Rule 506(b) Private Offering*, VARNUM (Sep. 6, 2018), https://www.varnumlaw.com/pp/publication-reasons-to-include-only-accredited-investors-in-your-rule-506b-private-offering.pdf (listing disclosure requirements, small amount of capital raised from non-accredited investors and litigation risks, as reasons why a vast majority of Rule 506 offerings are made to accredited investors).

51 *See* SEC, STAFF REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 7 (Dec. 18, 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf [hereinafter "ACCREDITED INVESTOR" REPORT].

52 Rule 146, which preceded Regulation D, required that offerees be both wealthy and sophisticated, implying that wealth alone is not a satisfactory proxy for sophistication. *See* Oguss, *supra* note 1, at 285 n.13.

53 "ACCREDITED INVESTOR" REPORT, *supra* note 51, at 89. *But see id.* at 44–46 (discussing studies that "lend support to the theory that wealth is correlated to financial sophistication"). FINRA's 2015 NFCS Investor Survey found that while accredited investors might test better than non-accredited investors, even accredited investors do not test better than the middle range. *See* FINRA INV'R EDUC. FOUND., INVESTORS IN THE UNITED STATES (2016). According to a recent report, the percentage of U.S. households who would qualify as "accredited investors" has increased from less than 4% to over 12% since 1990, due to the inflationary effects on the wealth and income tests that have not been significantly changed. Jean Eaglesham & Coulter Jones, *Opportunities to Invest in Private Companies Grow*, WALL ST. J., Sep. 24, 2018, at B1. This increase would be justifiable if the percentage of financially sophisticated U.S. households had also tripled since 1990. However, evidence suggests that it has not.

54 "ACCREDITED INVESTOR" REPORT, *supra* note 51. The SEC staff recommended that the Commission consider permitting individuals to invest if they meet minimum investment thresholds, have professional credentials, have certain investment experience, are knowledgeable employees of private funds or pass an examination. *Id.* at 78.

commentators have questioned the value of the accredited investor standard[55] and recommended a variety of alternatives.[56]

B. Non-Accredited Investors: Disclosure, Knowledge and Experience

The disclosure and knowledge and experience standards in Rule 506 apply only to non-accredited investors.[57] While imprecise, they reflect the principles of *Ralston Purina*, implying that the investor in a private offering should be financially sophisticated, with access to pertinent information about the issuer. Indeed, disclosure can address business and market risks if a private investor has the requisite knowledge and experience to interpret the disclosure. The

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[55] Some have argued that the standard is too broad because it includes purchasers who are unsophisticated, or too narrow because it excludes investors who are financially knowledgeable. *See, e.g.*, Finger, *supra* note 1, at 748. One commentator summarized this state of affairs. *See* Oguss, *supra* note 1, at 289–91 ("Criticisms of wealth- and size-based sophistication proxies often lead commentators to three arguably contradictory arguments: (1) federal securities laws are overprotective of small investors and should be relaxed because they unfairly bar less wealthy investors from potentially lucrative opportunities, (2) federal securities laws are underprotective of large investors and should be strengthened, and (3) federal securities laws are both overprotective of small investors and underprotective of large investors and should be adjusted accordingly.") (citations omitted). *But see* Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L. REV. 225, 290 (1990) ("The fact remains . . . that all individuals or entities who fall within the various accredited investor categories, including the individual annual income and net worth categories, have the financial ability to purchase the advice they need."). Some commentators have argued that wealth standards, such as the "accredited investor" requirement, were designed to ensure that purchasers had adequate liquidity to hold presumably illiquid securities for a long period. *See* Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2281 (2014).

[56] Some have recommended investor credentialing. *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 280 (2000); Haq, *supra* note 1, at 77–78. Others have recommended examination of an investor's financial knowledge. *See, e.g.*, Finger, *supra* note 1, at 758–59; Oguss, *supra* note 1, at 311. Commentators have recommended an increase in the wealth and income thresholds. *See, e.g.*, Oguss, *supra* note 1, at 313. Alternatively, some have recommended a limitation in the percentage of total wealth that can be invested. *See, e.g.*, Cable, *supra* note 55, at 2310 (suggesting a diversification and a liquidity test); Oguss, *supra* note 1, *at* 314; *cf.* JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 tit. III (2012) (setting investment limits based on net worth and annual income). Finally, others have recommended other options, such as a sliding scale of wealth or income, a limitation on investment in any one company, exclusion of illiquid assets and nondiscretionary income, or a leverage limitation. *See, e.g.*, Haq, *supra* note 1, at 78. Some of these recommendations, such as the total wealth percentage limitation, are motivated by the belief that only investors who can bear the potential financial loss associated with the investment should be permitted to purchase in a private offering. This conclusion is incongruous with the structure of the Securities Act and the Supreme Court's decision in *Ralston Purina*.

[57] *See* 17 C.F.R. § 230.506(b)(2)(ii) (2019).

investor's knowledge and experience are useful only if he or she receives the necessary disclosure.

Nevertheless, Rule 506 does not appear to provide much protection to non-accredited investors. Although Rule 506 requires disclosure, it does not require the preparation of an audited financial statement of the issuer. Moreover, no underwriter offers the securities subject to strict liability for the disclosure.[58] Thus, the integrity of the disclosure can be questionable.

The knowledge and experience standard, which applies to the investor or his purchaser representative, suffers from imprecision.[59] The rule provides no criteria for ensuring that a non-accredited investor or its agent possesses the knowledge and experience necessary to evaluate the private offering. Instead, it relies upon the "reasonable belief" of the issuer, without describing whether this belief can be based upon an investor's years of investment experience, history of investing in private offerings, or other credentials, such as a CFA Institute charter or another qualification.[60] The SEC has declined to offer guidance on the "reasonable belief" element.[61] In regards to a similar requirement in former Rule 146, one commentator stated that "the term 'reasonable' cries out for facts to supply the context in which reasonableness will be determined, and that in turn gives courts great discretion in resolving this question of fact."[62]

Moreover, Rule 506 imposes no obligation on the purchaser representative upon whom the non-accredited investor might depend. Although the purchaser representative is acting as the investor's agent, there is still "agency risk" associated with this relationship since some purchaser representatives may act in a manner conflicting with the investor's best interest. Not only does Rule 506 not address these agency risks; it fails to impose any obligation on the purchaser representative acting as the non-accredited investor's agent.

Rule 506(d) disqualifies an offering from the exemptions of Rules 506(b)-(c) if the issuer, or any other person covered in paragraph (d), has a relevant criminal conviction, regulatory sanction, court order or any other disqualifying event pending against them.[63] Among the persons covered are "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities."[64] However, purchaser

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58 *Cf. id.;* Securities Act § 11, 15 U.S.C. § 77k (2018) (imposing strict liability for registered offerings).

59 *See generally* Heumann, *supra* note 33, at 6–7 (discussing former Rule 146).

60 *See* 17 C.F.R. § 230.506(b)(2)(ii).

61 *See* Interpretive Release on Regulation D, Securities Act Release No. 33,6455, 48 Fed. Reg. 10,045–46 (Mar. 10, 1983).

62 Heumann, *supra* note 33, at 12–13.

63 *See* 17 C.F.R. § 230.506(d).

64 *Id.*

representatives are not specifically covered by paragraph (d). Unless the purchaser representative is compensated for soliciting investors, the fact that the purchaser representative was convicted of fraud, for instance, might not disqualify a sale to a non-accredited investor.[65]

Thus, Rule 506 provides little assurance that non-accredited investors have reliable information, or the knowledge and experience necessary to evaluate the business and market risks associated with a private placement. Retention of the purchaser representative presents agency risk to the investor, which the rule does not mitigate. In short, there is little reason to believe that non-accredited investors can fend for themselves.

Additionally, even if Rule 506 did protect non-accredited investors, it hardly encourages access by non-accredited investors to private placements. These investors generally purchase in smaller amounts compared to accredited investors. Therefore, the limited benefit of placing private shares in the hands of the non-accredited investors typically will be exceeded by the cost of preparing the disclosure, limiting the offering to 35 non-accredited investors, and appraising the knowledge and experience of the investor or his purchaser representative.

IV. ANIMATING THE PURCHASER REPRESENTATIVE

As the author has previously suggested, the federal securities laws can be viewed as a means to address investment risk.[66] The provisions in the various statutes protecting non-accredited and other retail investors can be categorized according to the type of risk that they address. For example, if a provision in the Securities Act addresses the business and market risks of an issuer and provisions in the Securities Exchange Act of 1934 ("Exchange Act") address the same risks, the SEC might consider whether the method that one statute offers could be preferred to the method available in another statute, or whether these provisions might be redundant and the law simplified. By viewing the federal securities laws as a means to address different types of investment risk, the SEC may simplify securities regulation, reduce unnecessary burdens to capital formation and more effectively protect investors.

Rule 506 presents a good case study for how the SEC should apply this methodology. As the rule is currently structured, a retail investor, either acting alone or through a purchaser representative, will likely lack the knowledge, experience and information necessary to understand the business and market risks associated with the offering. Yet the law requires a registered investment adviser or broker-dealer to consider these risks when it recommends a private

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[65] *See id.*

[66] *See* Selman, *supra* note 19.

placement to its customers. By requiring the purchaser representative to be a registered investment adviser or broker-dealer, subject to a best interest standard and other obligations, the SEC could transfer the burden of analyzing the business and market risks from the retail investor to a purchaser representative who is legally obligated to conduct a reasonable investigation of the offering.

A. Regulation of Broker-Dealers

Broker-dealers that do business with the public generally must become members of the Financial Industry Regulatory Authority ("FINRA"), a national association registered with the SEC under Section 19 of the Exchange Act.[67] FINRA comprehensively regulates all aspects of a broker-dealer's business, such as by imposing just and equitable principles and specific sales practice standards and requiring registration, qualification and supervision of registered representatives. FINRA monitors broker-dealers for compliance with FINRA and SEC rules and has broad sanctioning authority to expel specific broker-dealers and their associated persons from the industry if they have violated those rules.[68] The SEC examines FINRA regularly to ensure that it is complying with its statutory responsibilities.

Broker-dealers must also comply with the SEC's "Regulation Best Interest," which requires that they act in the best interest of their retail customers when they provide recommendations, adopt policies and procedures for compliance, fully and fairly disclose material facts, including those about any potential conflicts of interest, and in some instances, mitigate or eliminate conflicts.[69] Regulation Best Interest becomes effective in June 2020.

The antifraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act,[70] Section 10(b) of the Exchange Act[71] and Rule 10b-5,[72] require any broker-dealer that recommends a security to conduct a reasonable investigation about the security and the issuer's representations about it.[73] In recommending a security, the broker-dealer is presumed to represent to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such

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67 *See* Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2018).

68 *See Id.*

69 *See* SEC, REGULATION BEST INTEREST: A SMALL ENTITY COMPLIANCE GUIDE (2019), https://www.sec.gov/info/smallbus/secg/regulation-best-interest.

70 *See* 15 U.S.C. § 77q(a) (2018).

71 *See* 15 U.S.C. § 78j(b) (2018).

72 *See* 17 C.F.R. § 240.10b-5 (2019).

73 *See, e.g.*, SEC v. N. Am. Research & Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970); Hanly v. SEC, 415 F.2d 589, 595–96 (2d Cir. 1969).

investigation."[74] A more thorough investigation is required for "securities issued by smaller companies of recent origin,"[75] many of which may be engaged in private offerings. They are expected to exercise a "high degree of care" in investigating an issuer's representations.[76] The fact that a customer is sophisticated and knowledgeable does not obviate the obligation to investigate.[77] The same principles under the antifraud provisions, which impose an obligation on broker-dealers to conduct a reasonable investigation, may be imposed by FINRA Rule 2010,[78] requiring adherence to just and equitable principles of trade, and FINRA Rule 2020,[79] prohibiting manipulative and fraudulent devices.[80]

FINRA Rule 2111 requires that a broker-dealer have reasonable grounds to believe that a recommendation to purchase a security, including one in a private offering, is suitable for the customer.[81] A broker-dealer's analysis includes two elements: a "reasonable basis" suitability analysis, in which the broker-dealer must consider whether the recommendation is suitable for at least some investors; and a "customer specific suitability" analysis, in which the broker-dealer must consider whether the security is suitable for the customer to whom it would be recommended.[82] As part of its reasonable basis suitability analysis, the broker-dealer must conduct "a reasonable investigation into the offering and an understanding of its features, including the fees and expenses and use of proceeds."[83] A broker-dealer could violate the reasonable-basis suitability obligation if it did not understand the recommended security.[84] The reasonable investigation should concern such matters as the issuer and its management, the issuer's business prospects and assets, the claims being made in the offering and the intended use of proceeds.[85] FINRA has provided a list

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74 *Hanly*, 415 F.2d at 597.

75 *Id.*

76 *See* Everest Sec., Inc., Exchange Act Release No. 37,600, 1996 WL 487682, at *4 (Aug. 26, 1996), *aff'd in relevant part*, 116 F.3d 1235 (8th Cir. 1997).

77 *See Hanly*, 415 F.2d at 596.

78 *See* FINRA, RULE 2010 (2008).

79 *See* FINRA, RULE 2020 (2008).

80 *See* FINRA, REGULATORY NOTICE 10-22, REGULATION D OFFERINGS: OBLIGATION OF BROKER-DEALERS TO CONDUCT REASONABLE INVESTIGATIONS IN REGULATION D OFFERINGS 3 (2010), https://www.finra.org/sites/default/files/NoticeDocument/p121304.pdf [hereinafter FINRA REGULATORY NOTICE 10-22].

81 *See* FINRA, RULE 2111 (2014).

82 *See generally* FINRA REGULATORY NOTICE 10-22, *supra* note 80, at 4.

83 Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendments and Order Granting Accelerated Approval of Proposed Rule Change to Adopt FINRA Rule 5123, Exchange Act Release No. 34,67157, 77 Fed Reg. 35,461 n.34 (July 13, 2012).

84 *See* FINRA, RULE 2111.

85 *See generally* FINRA REGULATORY NOTICE 10-22, *supra* note 80, at 5.

of practices to the broker-dealer industry that some firms have adopted to assist them in adequately discharging these responsibilities. The practices include a thorough review of the issuer's governing documents, financial statements, contracts, pending litigation, disciplinary history and management compensation.[86]

Faithful adherence to its obligations would require that a broker-dealer conduct a reasonable investigation into the business and market risks of a private issuer.[87] FINRA Rule 5123 helps to ensure that broker-dealers meet these obligations by requiring each broker-dealer selling an issuer's securities in a private placement to retail investors to file a copy of any offering document with FINRA, within 15 calendar days of the date of sale.[88] The filing requirement is designed to enable FINRA to better monitor firms' compliance with their suitability obligations by having its trained staff analyze data in the filings to identify those that contain red flags. FINRA staff contacts members who have made a filing with red flags to inquire about "the scope and results of their investigations pursuant to their suitability rule obligations."[89] Regulation of the distribution of private offerings to retail investors continues to be a priority for FINRA's regulatory programs. FINRA's "2019 Risk Monitoring and Examination Priorities Letter" emphasizes the fact that FINRA will evaluate how broker-dealers conduct their suitability analysis concerning private offerings distributed through online platforms, and the overconcentration of private offerings in a customer's account.[90] Moreover, FINRA has brought enforcement actions against broker-dealers who violated the suitability rule when they distributed private offerings.[91]

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86 *See id.* at 8–10.

87 *See* FINRA, RULE 2111 supp. material at 2111.05(a) ("A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.").

88 *See* FINRA, RULE 5123 (2013). This rule is administered similarly to FINRA Rule 5122, which concerns private placements by broker-dealers and control entities. *See* FINRA, RULE 5122 (2011).

89 *Id.*

90 *See* FINRA, 2019 RISK MONITORING AND EXAMINATION PRIORITIES LETTER 2–3 (2019), https://www.finra.org/sites/default/files/2019_Risk_Monitoring_and_Examination_Priorities_Letter.pdf.

91 *See, e.g.*, Spencer Edwards, Inc., Disciplinary Proceeding No. 2014041862701, 2018 WL 6630195 (FINRA OHO Nov. 14, 2018); Carolina Fin. Sec., LLC, Disciplinary Proceeding No. 2014040295201, 2017 WL 3309827 (FINRA OHO May 26, 2017); Red River Sec., LLC, Disciplinary Proceeding No. 2013035344201, 2017 WL 1149229 (FINRA OHO Feb. 9, 2017); Complaint, McBarron Capital LLC*,* Disciplinary Proceeding No. 2015044211103 (FINRA OHO Oct. 25, 2016); Harold Lee Connell, No. 2016051493702 (FINRA AWC June 12, 2018); First Am. Sec., Inc., No. 2015046056405 (FINRA AWC Nov. 7, 2016).

B. Regulation of Investment Advisers

Registered investment advisers are subject to a fiduciary duty to their clients, which is comprised of duties of loyalty and care.[92] The adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own.[93] An adviser that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict.[94] In addition, Section 206(3) of the Investment Advisers Act of 1940 ("Investment Advisers Act") prohibits an adviser, acting as principal for its own account, from effecting any sale or purchase of any security for the account of a client, without disclosing certain information to the client in writing before the completion of the transaction and obtaining the client's consent.[95] The SEC examines Commission-registered investment advisers for compliance with these requirements and has broad authority to enforce investment adviser compliance with the federal securities laws.[96]

According to the SEC, embedded in this fiduciary duty is a suitability obligation similar to the one that FINRA uses for regulating broker-dealers.[97] The investment adviser's duty of care requires both a reasonable belief that a recommendation is in the client's best interest, and a reasonable investigation into the investment itself.[98] The investment adviser must also consider the investment product's objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit.[99]

Broker-dealers and investment advisers must act in their clients' interest when they recommend private placements, and they may make such a

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92 *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 2019 WL 3779889, at *1 (June 5, 2019) [hereinafter Commission Interpretation]. *See generally* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

93 Commission Interpretation, *supra* note 92, at *7.

94 *Id.* at *7–8.

95 *See* 15 U.S.C. § 80b-6(3) (2018).

96 *See generally* 15 U.S.C. §§ 80a-1 to 80b-21 (2018).

97 *See General Information on the Regulation of Investment Advisers*, SEC (Mar. 11, 2011), sec.gov/divisions/investment/iaregulation/memoia.htm ("As fiduciaries, investment advisers owe their clients a duty to provide only suitable investment advice.") (citing Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406, 59 Fed. Reg. 13,464 (Mar. 16, 1994)).

98 *See* Commission Interpretation, *supra* note 92, at 16.

99 *Id.* at 17.

recommendation only after a reasonable investigation of the offering. An exemption based on the requirement that a purchaser representative be a federally regulated broker-dealer or investment adviser could enhance the ability of retail investors to obtain an informed evaluation of the business and market risks associated with a private placement.

C. Addressing the Agency Risks of a Broker-Dealer or Investment Adviser

Only about 20% of new non-fund private offerings are distributed through a broker-dealer or other intermediary.[100] The rest are sold directly by the issuer. The retail purchaser of an issuer-sold offering is on his own, destined to analyze the issuer's business and market risks without any assistance from a financial professional.

Our proposed exemption would provide an alternative for the retail investor who is represented by a federally regulated broker-dealer or investment adviser, subject to a best interest standard. Our exemption would raise the level of protection that Regulation D provides to the retail investor today. The business and market risks otherwise addressed by securities registration and prospectus disclosure instead would be addressed by federal regulation of the financial intermediary. Of course, investment advisers and broker-dealers do present another type of risk—agency risk. Federal regulation of broker-dealers and investment advisers addresses this risk, which is often influenced by intermediary's form of compensation and relationship to the issuer and investor. For example, commissions earned by a broker-dealer could encourage solicitations for transactions that are not in the customer's best interest. An investment adviser who earns an asset-based fee, regardless of effort, might not tend to the customer's needs. An intermediary's financial interest in the issuer might corrupt his recommendation to the customer. Federal regulation, such as the imposition of the best-interest standard, addresses these agency risks.

Should it adopt the proposed exemption, the SEC should augment these protections. The business and market risks of a private placement are high and the confluence of this business and market risk with the agency risks presented by the intermediary would justify additional protection. The SEC should carefully consider the conflicts of interests that might interfere with the intermediary's obligation to conduct a reasonable investigation and how federal law, including Regulation Best Interest and the investment adviser's fiduciary

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100 SCOTT BAUGUESS ET AL., DIV. OF ECON. & RISK ANALYSIS, SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009-2017, at 36–37 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf.

duty, should regulate those conflicts. Any significant conflict of interest that the financial intermediary cannot mitigate, it should be required to eliminate.

For example, the proposed exemption should be unavailable for a private offering of securities of the broker-dealer, investment adviser or any of its affiliates, in addition to any private offering in which the broker-dealer or investment adviser has a financial interest or stands to benefit as an insider of the issuer. Regulation D generally does not permit the purchaser representative to be "an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer."[101] The investment adviser or broker-dealer recommending a private offering under the proposed exemption should also be prohibited from being an affiliate or insider of the issuer. Specifically, they should not hold any financial interest in the issuer, regardless if it is less than a 10 percent ownership stake. Moreover, the purchaser representative today is permitted to have a material relationship with the issuer or its affiliates provided that this fact is disclosed to the investor. As a qualification for our proposed exemption, the SEC should prohibit any defined "material relationship" between an investment adviser or broker-dealer and the issuer or its affiliates. Disclosure to the investor is not sufficient mitigation of the conflict of interest that some relationships might present.

The SEC also should provide guidance concerning the type of information that the broker-dealer or investment adviser must obtain in order to fulfill their obligation to conduct a reasonable investigation of the investment. At a minimum, broker-dealers and investment advisers should be expected to obtain the same information as issuers must provide to non-accredited investors today.

V. Effect of Noncompliance with a Duty – Rescission?

This article does not propose that the availability of the exemption depend upon fulfillment by a purchaser representative of Regulation Best Interest, the investment adviser's fiduciary duty, or another requirement imposed by federal law as a result of its registration. The exemption for the issuer should simply require participation by a qualified purchaser representative obligated to meet those requirements. Behavior of a purchaser representative that is later determined to have violated Regulation Best Interest or another requirement should not give rise to rescissionary damages from the issuer, but rather expose the purchaser representative to possible enforcement action by the SEC or FINRA.

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[101] *See* 17 C.F.R. § 230.506 (2019); 17 C.F.R. § 230.501(i) (2019).

VI. REDUCED BURDENS FOR ISSUERS[102]

Rule 506 imposes three principal requirements on the issuer to non-accredited investors: the knowledge and experience analysis, the disclosure requirement and the limitation on offering size.[103] Adoption of the proposed exemption would render each of these requirements superfluous.

A. Analyzing the Purchaser Representative's Knowledge and Experience

A federally regulated investment adviser or broker-dealer who today is authorized to recommend private placements, and who must conduct a reasonable investigation of those recommendations, possesses the knowledge and experience to understand the business and market risks that they present. Therefore, there should be no need to require the issuer to analyze the knowledge and experience of the investment adviser, broker-dealer or investor. The issuer should be expected to verify that the purchaser representative has registered as an investment adviser or broker-dealer, which is a simpler test.

B. Disclosure to Investors

The investment adviser or broker-dealer should be required to obtain the disclosure necessary to fulfill its obligation to conduct a reasonable investigation. Disclosure to the financial intermediary, and the responsibility of the financial intermediary to evaluate the business and market risks on the investor's behalf, should make the requirement that the issuer disclose information to the investor unnecessary.[104] Indeed, the SEC should adopt the healthier presumption that the investor lacks the financial sophistication

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[102] The Concept Release requested comment on whether an accredited investor, advised by a registered financial professional, should be permitted to purchase private funds under Section 3(c)(1) of the Investment Company Act. *See* Concept Release, *supra* note 6, at 30,478. While this question lies beyond the scope of this article, if the SEC were to adopt an exemption that required the purchaser representatives to be registered as a broker-dealer or investment adviser, the SEC should consider the extent to which the investor protection provisions provided by these registration categories would address the risks presented by pooled investment vehicles.

[103] *See* 17 C.F.R. § 230.506.

[104] The Concept Release suggests that issuers may limit their Rule 506(b) offerings to accredited investors to avoid the disclosure requirements. *See* Concept Release, *supra* note 6, at 30,484. The Concept Release also requests comment on whether the SEC should eliminate or scale the information requirements in Rule 506(b) if non-accredited investors are advised by a financial professional or purchaser representative. *Id.* at 30,486.

necessary to understand the disclosure. Of course, the investment adviser or broker-dealer should be free to share issuer information with the investor.[105]

C. Offering Size

The exempt offering should be permitted to more than 35 non-accredited investors. *Ralston Purina* would seem to permit a larger offering, and there seems to be little justification to limit the offering size. The exemption should also permit general solicitation of the offering.[106]

By reducing these burdens on the issuer and shifting them from the issuer to the purchaser representative, the SEC would better protect retail investors and encourage issuers to include them in their private offerings. The disclosure requirement and the litigation risk of offering private shares to unsophisticated investors have been mentioned as reasons why private issuers do not like to do so.[107] Eliminating the disclosure requirement would alleviate this burden. It is possible that litigation risk also would be mitigated by the interposition of a registered broker-dealer or investment adviser, who is recommending the private offering to the investor.

In addition to the reduction of regulatory burdens, an issuer might find it easier to explain the private offering to a registered broker-dealer or investment adviser than to an unsophisticated investor. If this is true, private issuers might be more willing to offer their shares under the exemption. Of course, the fact that these investors will be expected to purchase smaller amounts might continue to discourage issuers.

VII. SUPPLEMENT OR REPLACE?

A final question concerns, in the words of the SEC, the "exemptive framework." Should the proposed exemption replace the existing exemptions for private offerings or should it merely supplement them?

The author recommends that the proposed exemption replace the part of Rule 506 concerning non-accredited investors. The proposed exemption would enhance investor protection and could provide non-accredited investors with more access to viable private offerings.

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105 *Cf.* Van Dyke v. Coburn Enters., 873 F.2d 1094, 1098 (8th Cir. 1989) (finding that a suggestion to investors to show information to an attorney and accountant evidences access to necessary information); Weprin v. Peterson, 736 F. Supp. 1124, 1129 (N.D. Ga. 1988) ("Many of the investors were also represented by [a broker-dealer], which had access to additional information and would provide it upon request to any investor.").

106 *Cf.* 17 C.F.R. § 230.506(c).

107 *See generally supra* note 50.

This article is not intended to suggest that the proposed exemption replace the accredited investor standard. Nevertheless, substituting the knowledge and experience of a registered broker-dealer or investment adviser for that of an accredited investor might better ensure that the accredited investor is protected. The author suggests that the SEC monitor implementation of the proposed exemption to determine its effects on the accredited investor marketplace. After time has passed and information is collected, the SEC can evaluate whether private offerings have been made to accredited investors under the exemption, and whether the exemption might serve as a substitute for the accredited investor exemption. Even if it does not serve as a substitute, the proposed exemption might enable Congress or the SEC to increase the thresholds for the definition of "accredited investor."