JEB HENSARLING, TX , CHAIRMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

October 30, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Chair White:

We write to express our concerns with the Securities and Exchange Commission's ("Commission") evaluation of the definition of the term "accredited investor." Additionally, we disagree with the Government Accountability Office's ("GAO's") analysis of the accredited investor issue and urge the Commission to recognize the flaws in the GAO study and properly qualify its conclusions. Finally, we seek answers to specific questions set forth below as well as responsive documents to enable our respective subcommittees to thoroughly evaluate potential improvements to the definition of accredited investor and to understand how the GAO came to its conclusions.

The Commission's Proposal

On July 10, 2013, the Commission issued Release No. 33-9416 titled *Amendments to Regulation D, Form D and Rule 156 under the Securities Act* ("Proposed Rules"). The Proposed Rules request comment on the definition of accredited investor. Specifically, at page 95 the proposal asks:

> Are the net worth test and the income test currently provided in Rule 5-1(a)(5) and Rule 501(a)(6), respectively, the appropriate tests for determining whether a natural person is an accredited investor? Do such tests indicate whether an investor has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment? If not, what other criteria should be considered as an appropriate test for investment sophistication.

We are pleased that the Commission appears to be considering expanding the definition of accredited investor to include sophisticated investors. As the Supreme Court said in *Securities and Exchange Commission v. Ralston Purina Co.*, "[a]n offering to those who are

shown to be able to fend for themselves is a transaction not involving any public offering."[1] As your questions logically imply, it would seem obvious that, in addition to those who meet wealth and income tests, financially knowledgeable investors would be capable of determining for themselves the merits and risks of a prospective investment.

The GAO's Analysis

On July 18, 2013, the GAO issued a report titled *Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered* ("GAO Study").[2] The first sentence of that report states one of GAO's central findings:

> Of the existing criteria in the [SEC's] accredited investor standard, many market participants identified net worth as the most important criterion for balancing investor protection and capital formation. For example, *two market participants said the net worth criterion, more so than income, likely indicates the investors' ability to accumulate wealth* and their investment knowledge." (Emphasis added.)

Unfortunately, by its focus on existing wealth accumulation measures with income measures, the GAO added little value to the debate over the definition of accredited investor. While those with substantial wealth or income should be allowed to invest in private offerings, it should not be to the exclusion of other knowledgeable investors. We disagree with the GAO's analysis and the exceedingly narrow measures by which it recommends evaluating investor accreditation.

In generating its conclusions, the GAO conducted interviews of only 27 participants, of which 11 were lawyers.[3] Such a small and biased sample fails to provide support for a regulatory change that may broadly impact capital formation across the U.S. economy. Accordingly, given these concerns associated with the GAO study, the Commission should largely discount its conclusions.

Statutory Authority and the Legislative Intent of Section 4(2) of the Securities Act of 1933

As you are aware, Rule 501 was adopted as part of Regulation D and intended to provide clarity to those offerings not deemed public under Section 4(2) of the Securities Act of 1933 and therefore exempt from the SEC's public offering registration requirements. Selling only to, or complying with sections that reference the concept of, accredited investors provides one avenue among many to conduct an offering exempt from public registration. Section 413(b)(2)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) specifies that the SEC may:

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[1] SEC v. Ralston Purina Co., 346 US 119 at 125.
[2] *Alternative Criteria for Qualifying As an Accredited Investor*, GAO-13-640, Report to Congressional Committees, p. 1 (July 2013).
[3] *Id.* at p. 38.

> by notice and comment rulemaking, make such adjustments to the definition of the term "accredited investor", as defined in section 230.215 of title 17, Code of Federal Regulations, or any successor thereto, as such term applies to natural persons, as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy.

The SEC may, therefore, consider any means permitted under the original statute to exempt offerings based on characteristics of the offerees. There is no indication from the legislative history of Section 413(b)(2)(B) that it in any way overrules prior legal interpretations of what legitimately constitutes a non-public offering. Thus prior legal precedent interpreting that section will continue to guide the SEC's rulemaking in this area. In this regard, and as stated in *SEC v. Ralston Purina*, "the focus of the inquiry should be on the need of the offerees for the protections afforded by registration."

The Commission has clear statutory authority to expand the definition of accredited investor to further economic opportunities for both individual investors and those businesses that seek capital.

Economic Cost-Benefit Analysis Requirements for SEC Rulemaking under the Securities Act of 1933

As required under the National Securities Markets Improvement Act of 1996, the Commission must promote efficiency, competition, and capital formation:

> CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.—Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[4]

OMB guidance on cost-benefit analysis[5] and the SEC's *Current Guidance on Economic Analysis in SEC Rulemakings*[6] require an evaluation of the costs and benefits of a proposed actions and the consideration of alternatives. Specifically, the SEC's current guidance imposes the following "substantive requirements for economic analysis in SEC rulemaking":

> It is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative

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[4] Section 2(b) of the Securities Act of 1933.
[5] Economic Analysis of Federal Regulations under Executive Order 12866 (January 11, 1996).
[6] *Current Guidance on Economic Analysis in SEC Rulemakings* from Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel to Staff of the Rulewriting Divisions and Offices (March 16, 2012).

> regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.[7]

Consistent with these requirements, when considering policy options pertaining to the definition of accredited investor, we expect the Commission to evaluate reasonable alternatives, including those presented herein.

Concern and Opportunity

Defining an accredited investor based solely on accumulated wealth or income imposes a broad constraint on this form of investment, shutting off countless investors from a market that can provide extraordinary benefits to capital formation and economic growth. A wealth test, to the exclusion of other methods of evaluation of accredited investors, is tantamount to the government sanctioning a special club – those who have already reached a certain level of wealth and are therefore deemed eligible for membership.

Any attempt by the Commission to further restrict investment to even wealthier investors will create the appearance that the wealthy are closing the door behind themselves. Accordingly, we remind the Commission of its ultimate priorities to promote capital formation and protect investors; we expect the Commission to do meaningful analysis to broaden investor access to a burgeoning Regulation D, Rule 506 market that in just the last few years has grown to a trillion dollars in annual issuances at a time when many other parts of our economy continue to struggle.[8] Given the broad constraint that presently applies within the accredited investor definition, the Commission has a great deal of room to expand investment opportunities and foster capital formation.

Information technology greatly expanded investors' ability to discover information about private companies relative to 1982, the year Regulation D was implemented. As a result, when considering the need for the protections afforded by registration, the improved ability for investors to "fend for themselves" further enables the Commission to expand the definition of accredited investor and enhance efficiency, competition and capital formation.

As the Rule 506 market expands and enables ever smaller businesses to raise capital, greater participation by sophisticated investors will improve price discovery and information dissemination for these smaller, lesser known private issuers. For example, those potential investors that do not meet wealth or income requirements, but have degrees, certifications or experience in accounting or finance, would increase the sophistication of the investor pool while also substantially increasing the amount of capital available for smaller private issuers.

Accordingly, we request that you consider multiple objective means by which investors can meet accreditation standards. Additionally, to assist our respective subcommittees in fulfilling their oversight responsibilities, please answer each of the following questions individually and provide, where requested, materials in support of responses:

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[7] *Id.* at p. 4.
[8] Release No. 33-9416 at p. 113.

1. We expect that permitting sophisticated investors, such as Certified Public Accountants ("CPAs") and Chartered Financial Analysts ("CFAs") to participate in private investment opportunities would improve information dissemination and analysis surrounding private investment opportunities. By excluding these highly trained financial professionals, unless they meet wealth or income tests, from investing in certain offerings, is the Commission placing existing accredited investors at greater risk? Would the review of investments by trained professionals with a vested interest help reveal problems of an issuer? Please perform an economic analysis that considers these points.

2. Do you agree that the inclusion of financially sophisticated smaller investors would increase the extent of expert review of smaller issuances in particular? Do you believe that less wealthy but sophisticated investors would be in a better position to pursue smaller investments that would otherwise be ignored by larger sophisticated investors? Please provide an economic analysis evaluating these points.

3. Do you agree that an expanded pool of potential accredited investors would help provide liquidity to private market investments, reducing risk to this type of investing? Please provide an analysis of the impact to liquidity that would result from any potential increase or decrease of accredited investors.

4. With regard to CPAs, CFAs, those with securities licenses, and those with degrees in business, finance, accounting or economics, please provide an analysis of whether these certifications should provide an independent basis to qualify as an accredited investor.

5. Why should experienced financial professionals, such as registered investment advisers, consultants, brokers, traders, portfolio managers, analysts, compliance staff, legal counsel and regulators, be required to independently qualify as accredited investors based on a wealth test?

6. Should reliance on a qualified broker or registered investment adviser enable ordinary investors to participate in Regulation D Rule 506 offerings? Why or why not?

7. Please provide an analysis of whether disclosure by those private issuers that anticipate using Regulation D 506(c) has increased following the lifting of the ban on general solicitation. If not, have the compliance challenges associated with the Proposed Amendments to Regulation D inhibited these potential 506(c) issuers from taking full advantage of the lifting of the ban?

8. The Regulation D 506 market raises equity capital in excess of one trillion dollars annually, a level that exceeds that of the combined public debt and equity markets. Would diminishing the pool of eligible investors potentially harm U.S. GDP? Why or why not?

9. Please provide all communications between the GAO and the SEC within the past 18 months referring or relating to the definition of accredited investors.

Please provide responses as requested in this letter as soon as practicable but not later than November 13, 2013. Any questions regarding this request should be directed to Peter Haller or J.W. Verret of the Committee staff at (202) 225-7502.

Sincerely,

PATRICK MCHENRY
Chairman
Subcommittee on Oversight and Investigations

SCOTT GARRETT
Chairman
Subcommittee on Capital Markets and Government Sponsored Entities

cc: The Hon. Al Green, Ranking Member
The Hon. Carolyn Maloney, Ranking Member