PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION
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August 31, 2023

Via Email Only: roger.patrick@com.ohio.gov
Roger Patrick
Department of Commerce
Division of Securities
77 South High Street
30th Floor
Columbus, Ohio 43215

Re: Regulation 1301:6-3-09 - Registration by Qualification

Dear Mr. Patrick:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

By way of Regulation Package 1301:6-3-09 Registration by Qualification, the Ohio Division of Securities has requested comment on whether changes should be made to existing rules, operations, or administrative procedures to permit the sale of Business Development Companies and non-traded REITs to public investors in Ohio in concentrations in excess of 10% of that investor's net worth.

Comment

As is the case with many such amendment proposals, PIABA strongly believes Ohio must balance the goal of promoting healthy capital raises while keeping a keen eye on preventing abuse. As history has clearly shown, Capital Formation is a fertile area for potential exploitation. For example, "In recent years, the private placement market outpaced the public market. From 2009 to 2019, the amount of capital raised in Regulation D offerings more than doubled…member

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involvement in private placements has kept pace with the growth of the Regulation D market in general. For instance, the number of Regulation D filings submitted by members pursuant to FINRA Rules 5122 and 5123 has increased to over 3,800 unique filings in 2021 in comparison to roughly 2,000 submissions in 2013."[1] The number of persons who can invest in private placements had increased substantially over the last several decades as well. In a December 2019 statement, SEC Commissioner Allison Herren Lee estimated that this accredited investor pool will grow to 22.7% of American households in the next decade.[2] The increasing pool of "accredited" investors means that more investors will not have the sophistication or financial wherewithal to adequately ascertain the risks of these investments. We find this trend concerning.

The financial motivation to sell these products over other registered investment options is obvious. These products range in commission between 5% and 8%. Those commissions are far higher than what brokers would make selling more typical investments, including mutual funds, stocks, or bonds. Take, for example, a registered Broker-Dealer Crown Capital. According to its own financial reports with the SEC, in 2020 it generated more in commissions selling partnerships than it did selling traditional equities.[3] Due to these factors, PIABA members see retail clients whose brokers generate huge proportions of their income, seeing even 90% of their total revenue, being generated from selling these types of products to retail customers.

These recommendations are problematic; these types of problems are widely acknowledged including non-traded real estate investment trusts.[4] These cautions have included warnings about the extremely limited liquidity, and very high fees associated with non-traded REITs. Moreover, due, in part, to the huge up-front costs, these products historically underperform their publicly traded counterparts. So, investors take far higher risks for far lower rewards. Despite this, brokers commonly tout the "stability" of these products relative to the stock market, which is nonsense once the premise is examined. The premise is known as the "stable investment" myth. The theory is because daily fluctuations are not reported, as they would be for publicly-traded investments, the private investments' intrinsic value does not fluctuate. Privately traded investments, or private companies in general, obviously have rising and falling values based on a host of factors. The fact that the investor does not see the fluctuations, as they are not public, does not mean the investment in question is not losing its value rapidly. And the regular "stable" reported value provides an unwitting investor a false sense of security.

The reality is that these types of products are almost invariably basically start-up businesses. They have no track record and no assets. They have an idea for a business and a plan. As a result, the investors are bearing the massive start-up costs that these businesses entail. Many of these investments carry up-front costs over 10%. That means that day 1, the investors are down that much money on their investment. Most of that money goes to the sponsors of the investment, or to the brokers selling them. The distributions investors are sold based upon are unsustainable, not guaranteed, and often fail.

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[1] Regulatory Notice 23-09, page 6.
[2] https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor#_ftnref6
[3] See Crown Capital, X-17A-5 (Dated March 2, 2021) at 8, available at https://www.sec.gov/Archives/edgar/vprr/2100/21002101.pdf.
[4] *See* FINRA, *Public Non-Traded REITs- perform a Careful Review Before Investing* (October 4, 2011).

The proposed changes to Ohio's rules are indicative of the challenges faced by regulators in an ever-expanding marketplace. But the suggestion that a self-executing online waiver permitting excessive private placement sales serves as a good guardrail is fundamentally flawed. First and foremost, it is entirely conceivable that an unscrupulous salesperson would use an investor's computer to log into the Division's web site and complete the form on behalf of their client. Next, the concept that risk disclosures make the private placement sales appropriate fails on any one of a number of levels. Studies have shown, repeatedly and conclusively, that risk warnings in these contexts are not meaningful to an unwitting investor. There is also the problem that arises when the wrongful broker or investment adviser argues that the online-sign off is proof positive that the client accepted the risk and waived any obligation for the seller to abide by their duties imposed by Reg BI for brokers (or a standard fiduciary duty for brokers where there is a special relationship of trust and confidence) or the fiduciary duty applicable to all investment advisers.

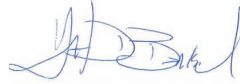
We would also point out that so-called "accredited investors" are more likely to fall for wildly optimistic sales pitches than are those investors with more modest means. Accredited investors, who have accumulated some degree of meaningful wealth, tend to be better educated people. Which raises an ironic twist: the more educated one is, the more likely one is to acknowledge the limits of their knowledge base and therefore rely on the advice of so-called experts. PIABA's members have represented countless wealthy investors who fell prey to wrongful sales practices for the simple reason that they figured their trusted financial advisors would treat them as they treat their own clients. As those investors would never dream of lying to a client, it confounds them that their hired financial advisors would lie to them. Therefore, one could credibly argue that accredited investors are *more* likely to lose money in private placements. PIABA does not support the suggested waivers for any investors, and especially not accredited investors.

On a personal level, and separate and apart from my role as President of PIABA, I have represented aggrieved investors throughout Ohio, through my offices in Cleveland, for more than twenty years now. While we see the number of cases related to private placements rise and fall, we *do* tend to see fewer of those cases within Ohio than we do for our clients residing elsewhere in the United States. The probable reason for the lower number of such cases in Ohio is our current 10% limit. The proposed changes that would modify that limit serve two purposes: promoting capital formation *and* promoting investor fraud. Absent evidence of a harm Ohio's citizens have suffered through an inability to raise capital using the current channels, it would be unwise to change a rule that has, in large part, worked to protect Ohio investors. Selling more private placements just to sell them works to no-one's advantage save those who are paid to make the sales and those who take the investors' money.

The current proposal permits unscrupulous salesmen to target those public investors in Ohio who tend to be the least knowledgeable about the unique risks these types of products carry, while simultaneously being those least able to bear the consequences if and when those risks materialize. Any proposals that encourage capital formation, by way of weakening existing protections within the corresponding Ohio rules, is perilous to consumers and vehemently opposed by PIABA membership. Accordingly, I, on my own behalf and as President of PIABA, strongly

believe that the current 10% concentration limits should remain in place, since removing them would expose individual investors to substantial additional risks which they are ill-equipped to endure.

Very Truly Yours,



Hugh D. Berkson
President, Public Investors Advocate Bar Association