



## CUTTING EDGE COUNSEL

LEGAL STRATEGIES FOR A NEW ECONOMY

The Port Workspaces, 344 Thomas L Berkley Way, Oakland, CA 94612  
(510) 834-4530 ~ cuttingedgecounsel.com

September 24, 2019

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

*Re: Response to Concept Release, Proposing Two New Local Fund Exemptions from 1940 Act*

To Whom It May Concern,

We are writing in response to the SEC's Concept Release issued June 26, 2019 (the "Release"), and in particular to part [IV.C](#) of the Release pertaining to retail access to pooled funds that invest in exempt offerings.

In the Release the SEC correctly points out that retail investors have very limited access to such funds. It bears emphasizing the importance of this gap in the investing landscape, an importance that arises from two key factors: First, "retail" investors comprise some 95% of the U.S. households; and while they may not control a majority of the aggregate investments in America measured in dollars, they nonetheless are -- for a host of reasons -- the most important investing segment.

Second, retail investors are increasingly focused on local/community investing. Just as "shop local" movements have sprung up across America in an effort to keep money circulating in their communities, there is a similarly growing recognition that "investing locally" is good for one's community for the same reasons. And just as donors give to local schools because they want to see their community thrive, retail investors need better tools to invest, not because they believe local investments will provide the highest ROI, but because it benefits their communities. These investments can produce a different but possibly even more valuable "return" by helping to create and preserve jobs, allowing locally-rooted companies to grow and maintain their businesses, and providing needed stability in areas that otherwise would be prone to decay.

In recent years the SEC has made important efforts to open up opportunities for retail investors to invest in their community, as we have seen with Regulation Crowdfunding, as well as in the



SEC's 2016 liberalization of the rules for intrastate and Rule 504 offerings. We applaud these efforts. And yet, it is also clear that many (and probably most) retail investors are not equipped, nor do they have the time, to do effective due diligence on Regulation Crowdfunding or direct public offerings. And particularly with offerings that proceed without any state or federal review, the reality is that bad deals will be offered, and are often more risky than retail investors realize. Consequently, many retail investors may end up losing much or all of their investment dollars on those deals due to their lack of enough sophistication to understand them.

We are not arguing, however, for a tightening of the rules for such offerings; any tightening of the rules will likely lead back to fewer opportunities to invest, which has been shown by many modern economists to only exacerbate the problems of rising income and wealth gaps. Rather, we are arguing for an alternative way to invest. We believe a significant answer to the above concerns is to allow retail investors to invest through diversified pooled investment vehicles -- i.e. "community investment funds," which can invest in local businesses. Such a fund would, like other funds, need to be professionally managed to do the necessary due diligence on any investments it makes. It would also stand a better chance of offering liquidity to investors than most local businesses can via direct investments.

There are four key requirements of a true community investment fund: (1) It must be open for investment by non-accredited investors. (2) It must be able to conduct general solicitation for those investors. (3) It must be able to invest in small and medium-sized local businesses and ventures. (4) It must be able to do so cost-effectively at a community scale -- which means it must be exempt from the Investment Company Act of 1940 without having to obtain an exemptive order.

There are strategies available under the Investment Company Act of 1940 that allow for some types of community investment funds. A charitable loan fund, for example, can pool debt capital from local investors and make loans to local organizations that further its charitable purpose. Within the real estate class of investment, it is also possible under the 1940 Act to create a true community investment fund. Each of these two types of community investment fund can rely on a simple-to-deploy exemption under the 1940 Act.<sup>1</sup>

But there is no simple exemption for funds that make equity investments in local businesses, which is the very type of investment that many small and medium sized companies need. This is the gap in the legal landscape that needs to be addressed in order to create more fair and equitable community investment opportunities. We therefore recommend the SEC create two new 1940 Act exemptions under the power granted to the SEC by Section 6(c) of the 1940 Act.

### ***Intrastate Fund Exemption***

There is a kind of intrastate fund exemption in Section 6(d) of the 1940 Act for a fund whose investors are all residents of one state. However, this exemption is essentially useless. As far as

---

<sup>1</sup> Charitable funds can rely on the exemption in Section 3(c)(10)(a)(1) of the 1940 Act; while real estate funds can rely on either the exemption in Section 3(c)(5) or on exclusion from the definition of an "investment company" in Section 3(a)(1). Each of these strategies is compatible with a direct public offering.



we can tell, this exemption has not been used since the 1970s, for several reasons: (1) it only applies to closed-end funds; (2) it is limited to \$10 million (as adjusted by the SEC); and (3) it requires an exemptive order from the SEC. Even worse, in the exemptive order process the SEC can impose any of the 1940 Act's requirements on the fund, and the SEC has historically imposed a broad range of requirements, such that a Section 6(d) intrastate fund cannot be cost-effectively formed and operated.

We are therefore recommending the SEC create a much simpler intrastate fund exemption with the following features:

1. As with Section 6(d), all investors in the fund must reside in the fund's home state.
2. It applies to both open- and closed-end funds.
3. It has no size limit.
4. Most importantly, it is self-executing; i.e. it does not require an exemptive order.

Such a fund would most likely raise capital via a direct public offering, relying on the intrastate offering exemption (Rule 147 or 147A) at the federal level and relying on a qualification by permit at the state level. This means that these funds will be fully vetted by state securities regulators, who will be best-equipped to enforce the state's own laws as they see fit. If there is a concern about the fund having no size limit, we note that neither charitable loan funds nor real estate funds have any size limit either. But this too should be a matter for states to regulate as they see fit.

### ***Small Fund Exemption***

While the intrastate fund exemption described above will meet the needs of most communities, we also recognize that some communities consist of a metropolitan area spanning two or more states, like Kansas City, Portland, or even Washington DC. For such communities we recommend the SEC create a small fund exemption that is similar to the intrastate fund exemption, except that instead of investors being limited to one state, this type of fund would be limited in size to \$50 million.

We believe that these new 1940 Act exemptions will promote stronger local economies, empower local/community investors, and help build wealth broadly across the economic spectrum.

Thank you for your consideration.

Sincerely,  
Cutting Edge Counsel, Inc.

Brian J. Beckon, Principal