Ava Badiee
JD, University of California, Irvine School of Law

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Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 2 0549

Re: File No. 4-692—Comment on Review of the Definition of "Accredited Investor"

Dear Mr. Fields:

I am submitting this comment letter in response to the SEC's review of the definition of an accredited investor within Regulation D. This comment is in the form of an essay on the issue and overall recommends that the SEC 1) adjust the net worth threshold for inflation, and 2) adopt a sophistication test. The comment focuses on the history of accreditation standards, the changing investment landscape, and the intent behind the adoption of the Securities Act and Regulation D.

INTRODUCTION

The existence of fraud in the securities industry resulted in state and federal regulators adopting securities regulatory schemes to protect investors. State securities laws seek to protect investors by evaluating the merits of a securities offering—ensuring that the security being offered is not too speculative. The federal securities laws, on the other hand, aim to protect investors by providing the public with full disclosure of the character of securities sold. Both the federal and state laws have successfully eliminated a large amount of fraudulent offerings, however, this paper will mainly focus on federal securities laws—specifically the Securities Act of 1933 ("Securities Act").

In imposing disclosure requirements, the Securities Act delineates two types of securities offerings: public and private. Public offerings must be registered and approved by the SEC, while private offerings are exempt from these requirements. Initially, exemptions were decided by the size and manner of the offering, among other things, but in 1953, the Supreme Court clarified the scope of what qualifies as a public offering. The Court determined that certain financially sophisticated individuals do not need the full protection of federal securities laws and can claim exemptions from mandatory disclosure requirements.

This concept has materialized into a number of active accreditation laws and regulations, the most important of which is the accredited investor definition in Regulation D, which is an exemption from the mandatory registration and disclosure requirements of the Securities Act. Because Rule 506 of Regulation D is the most utilized exemption from Securities Act requirements, the definition of an accredited investor plays a significant role in capital formation and the investment world. With Dodd-Frank's mandate that the rules be reviewed every four years, the inadequacies and strengths of the current standard are widely debated with a large group of individuals arguing that the standard be expanded beyond a strictly wealth-based requirement.

Part I of this paper will examine the emergence of accreditation standards. Part II will evaluate the current investment landscape. Part III will analyze the current accredited investor definition. Ultimately, I conclude that by adjusting the current standard for inflation, and incorporating a sophistication test, the definition will more effectively comport with the concerns of the Securities Act, the Supreme Court, and the current investment landscape.

I. Emergence of an Accreditation Standard

a. Blue Sky Laws and the Securities Act of 1933

1. The Rise of Securities Regulation in the United States

The regulation of securities issuances in the United States dates back to the early twentieth century. The growth of industry in the United States spurred the availability of investment opportunities, particularly in railroad and municipal bonds.[1] While earlier securities were generally reliable investments, by 1910, there was a surge in the sale of speculative securities.[2] Speculative securities purported to pay a higher rate of return than traditional securities, which attracted investors because of rising interest rates.[3] Furthermore, promoters of these securities engaged in deceptive advertising techniques, including the promotion of non-existent mines, Central American plantations and irrigation systems.[4] Promoters of worthless stock would buy and sell "sucker lists," which are lists comprised of the names of individuals who had previously purchased worthless securities.[5] The victims of these deceptive and targeting advertising techniques were often middle-class Americans, including farmers and widows.[6] As a result, the public grew greatly concerned over the sale of these securities.

In 1911, Joseph Dolley, the Kansas Banking Commissioner, responded to these concerns by successfully lobbying for the implementation of the first "blue sky bill," to ensure that Investment Companies were regulated and supervised, and punished for fraudulent activity.[7] The law required Investment Companies selling securities in Kansas to obtain a license, file regular reports of financial condition, reports of a business plan, and a copy of all securities proposed for sale.[8] The bank commissioner was authorized to ban an investment company from the State if he concluded that the information about the security contained unfair, unjust, inequitable or oppressive provisions, or if the investment company was not solvent, did not intent to do a fair and honest business, and did

[1] Jonathan R. Macey & Geoffrey P. Miller, *Origin of Blue Sky Laws*, 70 Tex. L. Rev. 347, 353 (1991).
[2] *Id.*
[3] *Id.*
[4] North American Securities Administrators Association, A Century of Investor Protection 1 (1911-
[4] North American Securities Administrators Association, A Century of Investor Protection 1 (1911-2011).
[5] H.B. Matthews, *The "Sucker List*," 86 BANKERS MAG. 174, 174 (1913).
[6] North American Securities Administrators Association, A Century of Investor Protection 1 (1911-2011)
[7] *Id.* at 2.
[8] Macey, *supra* note 1, at 360.

not promise a fair return on the stocks, bonds, or other securities offered for sale. The law immediately began to have positive effects. Many companies withdrew their applications after finding out about the investigatory process, and many criminals fled the state after finding out about the strict fines and penalties.[9] In the 18 months following the law's enactment, of the 1,500 companies that applied to conduct business in Kansas, only 100 were approved.[10] The success of this law inspired other states, and even other countries, to implement similar laws.[11]

In October 1929, federal lawmakers began regulating securities because of the collapse of the financial markets. The Securities Act was enacted in 1933 to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[12] The purpose of the statute was to protect ordinary investors from inadequate disclosures, fraudulent stock dealings, and to establish confidence in the market for newly issued securities.[13] In pursuit of this goal, Section 4(a)(2) of the Securities Act requires issuers to comply with registration and disclosure requirements when engaging in public offerings, and provides exemptions for certain private offerings. The legislative history of the Act shows that the private offering exemption allowed an issuer to sell its securities to a particular person where there was no practical need for the bill's application or the benefits were too remote.[14] While considering what constitutes a "transaction . . . not involving a public offering" under the Act, the Supreme Court in *Ralston Purina* clarified how this language applied to individuals by articulating the first investor accreditation exemption for natural persons in securities law.

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[9] Jonathan R. Macey & Geoffrey P. Miller, *Origin of Blue Sky Laws*, 70 Tex. L. Rev. 347, 353 (1991). It is important to note that the success of the Kansas Blue Sky Law has been historically contested with some saying that the success of the law was widely exaggerated.
[10] North American Securities Administrators Association, *supra* note 4, at 2.
[11] *Id.*
[12] Preamble to Securities Act; S. REP. 73-792.
[13] 77 Cong. Rec. 937 (1933).
[14] H.R. REP. NO. 73-85, 15–16

b. Ralston Purina's Development of the Investor Accreditation Exemption

In *Ralston Purina*, the Court articulated the criteria to consider when determining the availability of what is now the Section 4(a)(2) exemption.[15] Ralston Purina was a manufacturer and distributor of various feed and cereal products operating throughout the United States and Canada.[16] The company encouraged employees to purchase its stock, selling nearly $2,000,000 of stock to employees without complying with the registration requirements of the Securities Act.[17] The stocks were available to any "key employee" willing to purchase the stock at market value. This resulted in employees in all echelons of the corporate hierarchy purchasing the stock, including "employees with the duties of an artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterinarian."[18]

After examining the legislative purpose of the statute to protect investors, the Court concluded that the exemption should turn on whether "the *particular class of persons* affected needs the protection of the Act."[19] Thus, the Court found that a private offering is "an offering to those who are shown to be able to fend for themselves."[20] The touchstone of the exemption was the knowledge of the offeree, specifically whether the person had access to information typically

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[15] At the time of Ralston Purina, the predecessor of 4(a)(2) involving a transaction "not involving any public offering" was then-present in § 4(1). May 27, 1933, ch. 38, title I, § 4, 48 Stat. 77. It was redenominated as 4(2) in 1964. Pub. L. 88–467, § 12, Aug. 20, 1964, 78 Stat. 580.

[16] *SEC v. Ralston Purina*, 346 U.S. 119, 120 (1953).

[17] *Id.* at 121.

[18] *Id.*

[19] *Id.* at 125 (emphasis added).

[20] *Id.*

available in a registration statement.[21] The Court noted that executive personnel, unlike the petitioners here, would likely fall within this exemption because their position would give them unique access to this information.[22] Ultimately, Ralston Purina's stock issuances to employees were not found to fall within the exemption under the predecessor to Rule 4(a)(2) because its employees were not shown to have access to information a registration would disclose.[23]

c. Administrative and Statutory Investor Accreditation Schemes

Using *Ralston Purina* as a platform, lower Courts began to develop methods to determine when the exemption applied. Some developed numerical thresholds when determining if there has been a public offering,[24] while others reasoned, "wealthy persons and certain other persons such as lawyers, accountants and businessmen are 'sophisticated' investors who are not in need of the protections afforded by the Act." [25] Due to the inconsistent application of the exemption and concerns over the ability of small businesses to raise capital, in 1974, the SEC responded to the rise in private offerings by adopting Rule 146 to clarify for issuers when Rule 4(2) exemptions applied. The Commission believed that:

> creating greater certainty in the application of the Section 4(2) exemption would be in the public interest for two reasons; first to provide objective standards upon which responsible businessmen may rely and also to deter reliance on that section for offerings of securities to persons who are unable to fend for themselves in terms of obtaining information about the issuer and of assuming the risk of investment.[26]

Under Rule 146, an issuer had to meet three requirements for an offering to be exempt from the registration requirements of the Securities Act. First, the issuer must have reasonably believed

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[21] *Ralston Purina*, 346 U.S. at 125.
[22] *Id.*
[23] *Id.* at 127.
[24] SEC, Notice of proposed rule 146 under the securities act of 1933--"transactions by an issuer deemed not to involve any public offering and related form 146" and notice of a proposal to amend rule 257 under such act -- "offerings not in excess of $50,000, Release No. 5336 (November 28, 1972).
[25] Release No. 5336 (November 28, 1972).
[26] *Id.*

that the purchaser had the requisite knowledge and experience in financial matters to evaluate the risks of an investment or who could bear the economic risks of an investment. Second, the purchaser had to have the requisite knowledge and experience in financial matters unless they had hired a representative with this knowledge. Finally, the issuer had to offer the offeree information available in a registration statement. [27] In sum, whether an individual can bear the economic risk of the offering, and whether the individual is financially sophisticated based on knowledge, experience, and ability to evaluate risk of loss.[28]

In 1978, there was a growing concern for the ability of small businesses to raise capital due to the high costs of compliance with mandated registration and disclosure requirements. This prompted the SEC to adopt Rule 242, which introduced the accredited investor concept into federal securities law. Under Rule 242, certain domestic and Canadian issuers could sell their securities to an unlimited number of accredited investors or up to 35 non-accredited investors. Rule 242 defined an accredited investor as a person purchasing $100,000 of issuer's securities, an executive officer or director of the issuer or a specified type of entity, and did not require issuers to provide accredited investors with information provided in a registration filing.[29]

Congress responded to ongoing need for federal securities law reform by enacting the Small Business Investment Act of 1980 (Small Business Act), which again utilized an investor accreditation standard. The Act provided an exemption under Section 4(6) for offers and sales solely to accredited investors, defined as "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets

[27] C. Edward Fletcher III, Sophisticated Investors Under the Federal Securities Laws, 1988 DUKE L.J. 1081

[28] https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.

[29] U.S. Securities and Exchange Commission, *Report on the Review of the Definition of "Accredited Investor"*, U.S. Securities and Exchange Commission, Dec. 18, 2015.

under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." [30]

d. Regulation D

In 1982, after re-evaluating the exemption scheme under the Securities Act and discovering the previous standards restrained the ability of small businesses to raise capital, the SEC again utilized the accredited investor concept by adopting Regulation D.[31] Rules 501-506 of Regulation D list the exemptions from the registration requirements of the Securities Act.

Rule 506, which succeeded Rule 146, provides exemptions to: (1) accredited investors, and (2) up to 35 non-accredited investors if they have a financial advisor. Currently, both entities and natural persons can qualify as accredited investors. With respect to natural persons, an individual is an accredited investor if that person has (1) earned income exceeding $200,000 (or $300,000 together with a spouse in each of the prior two years, and reasonably expects to make the same amount for the current year),[32] or (2) has a net worth over $1 million, either alone or together with a spouse and excluding a primary residence.[33] The net worth and income threshold were meant to ensure adequate financial experience, sophistication, and bargaining power.[34] Because under Rule 506 an issuer can sell an unlimited amount of securities to an unlimited amount of accredited investors, it is preferred over Rules 504 and 505. As a result, 95% of Regulation D offerings are issued under Rule 506, making it the predominant capital market tool under Regulation D.[35]

[30] Small Business Investment Incentive Act § 603.
[31] Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales. 47 FR 11251-01 (march 16, 1982). 47 FR 11262
[32] While the $200,000 threshold has been in place since 1982, the $300,000 threshold, including spousal income, was established in 1988. *See* Regulation D Revisions, 53 Fed. Reg. 7866 (Mar. 10, 1988).
[33] Regulation D, Rule 501 (a)
[34] Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 For Transactions Involving Limited Offers and Sales, 46 Fed. Reg. 41791 (Aug. 18, 1981).
[35] DERA October Report

Furthermore, as of 2012, accredited investors accounted for 92% of reported Regulation D offerings.[36] In fact, most offerings are issued almost exclusively to accredited investors, especially in the venture capital context,[37] and about 99% of private offerings are conducted under Regulation D.[38] Consequently, the accredited investor threshold is extremely important in the realm of private placement.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the SEC to review this threshold beginning in 2014 and every four years thereafter to determine whether the threshold "should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." [39]

e. <u>Other Accreditation Standards</u>

Investor qualification exemptions are common in the financial regulatory world. There are several other laws and regulations implementing financial thresholds exempting issuers from complying with laws and regulations attached to certain transactions. These standards were adopted to provide exemptions to natural persons[40] that possess a high level of financial sophisticated necessary to not need the protection of applicable laws and regulations. The thresholds incorporate one of two qualifiers: an individual's investments or net worth.

A majority of these accreditation thresholds are based solely on investment experience, which reflects both Congress' and the financial regulator's perception that investment experience signals financial sophistication. We will evaluate a few examples. First, Rule 2(a)(51)(A) of the Investment Company Act exempts certain issuers from the definition of an "investment

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[36] DERA October Report.
[37] Steven J. Choi, Securities Regulation Cases and Analysis 562 (4th Ed. 2015); DERA 34 ("private offerings by VC funds only rarely include non-accredited investors (only 1% of offerings have at least one such investor.").
[38] DERA October Report.
[39] Dodd-Frank Act Section 413(B).
[40] Many of these also apply to entities, but that is outside of the scope of this paper.

company" where sales of securities are made solely to Qualified Purchasers, which is defined as an individual with $5 million in investments.[41] These investors were thought to be sufficiently financially sophisticated to evaluate the risks associated with investment pools not protected by the Investment Company Act.[42] Second, Section 18(b)(3) of the Securities Act exempts offerings to Qualified Purchasers from state securities registration and qualification requirements. For purposes of Regulation A offerings, Qualified Purchasers are any person to whom securities are sold in a Tier 2 offering, which is an offering of up to $50 million in a twelve-month period, including up to $15 million offered on behalf of security holders that are affiliates of the issuer.[43] Third, Rule 3(a)(54) of the Exchange Act provides banks with exemptions from broker-dealer registration when selling certain securities to qualified investors, which are individuals with $10 million in asset-backed securities and loan participations, and $25 million in other investments. Similar to Rule 2(a)(51)(A), these qualifications were thought to suggest investor sophistication and experience.[44] Further, Rule 144A provides an exemption from the registration of federal securities laws for resales of restricted securities to Qualified Institutional Buyers. A registered broker-dealer qualifies as a Qualified Institutional Buyer if it owns and invests at least $10 million in securities of issuers unaffiliated with the broker-dealer.[45] Finally, under the Commodity Exchange Act Section 1a(18), an Eligible Contract Participant is able to engage in certain derivatives and swaps

[41] NSMIA § 209(b); Investment Company Act § 2(a)(51)(A).
[42] https://www.sec.gov/rules/final/ic-22597.txt ("The Commission is adopting rules under the Investment Company Act of 1940 to implement provisions of the National Securities Markets Improvement Act of 1996 that apply to privately offered investment companies. The rules define certain terms for purposes of the new exclusion from regulation under the Investment Company Act for privately offered investment companies whose investors are all highly sophisticated investors, termed "qualified purchasers.")
[43] 17 C.F.R. 230.256; Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Release No. 33-9741 (Mar. 25, 2015) 80 FR 21806 (the "Regulation A+ Adopting Release").
[44] *See* Exemption of Certain Foreign Brokers or Dealers, Release No. 34-58047 (June 27, 2008) [73 FR 39182].
[45] 17 C.F.R. § 230.144A(a)(1)(ii).

transactions. An Eligible Contract Participant is an individual with $10 million in investments, or $5 million in investments if hedging.

The examples above reflect that investment experience is thought indicative of an investor's ability to fend for himself. Of the existing accreditation standards, only one of the standards incorporates a net worth requirement similar to the accredited investor standard. The Advisers Act Rule 205-3 provides an exemption from the general rule that Investment Advisors cannot charge performance fees to clients where the transaction involves a Qualified Client. A Qualified Client is defined as an individual holding $1 million in assets under management with an investment advisor, or $2 million in net worth excluding the value of a primary residence.[46] These thresholds are adjusted for inflation every five years.[47] The $2 million net worth requirement is similar to the accredited investor net worth requirement, but even under this provision, an individual can also qualify as a Qualified Client based on his investments.

It is apparent that financial regulators and Congress seek to ensure that securities laws do not inhibit the free market for investments by natural persons meeting the appropriate qualifications. However, it is interesting to note that none of the existing accreditation standards are based on net worth alone, and that every standard utilizes an investment experience requirement. While the investment criteria are typically high and inherently allow only the wealthy to qualify for these exemptions, the existence of investment criteria highlights that wealth alone is insufficient and that investor sophistication is an important inquiry in establishing an accreditation standard. The current accredited investor standard may need to be modified to comport with the trends in these statutes and regulations.

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[46] 17 C.F.R. § 275.205-3(d); U.S. Securities and Exchange Commission, *Report on the Review of the Definition of "Accredited Investor"*, U.S. Securities and Exchange Commission, Dec. 18, 2015 (articulating that the Commission excluded primary residences from the net worth threshold to promote regulatory consistency between this rule and the accredited investor definition).
[47] 17 C.F.R. § 275.205-3(e).

II. <u>Changing Investment Landscape</u>

The SEC should modify the definition of an accredited investor to reflect current trends in investment strategies by natural persons, and the private equity and venture capital market.

The demographic of persons investing in securities is markedly different than it was thirty-four years ago when Regulation D was first adopted. After the 2008 financial crisis, the American public's confidence in the banking system hit an all-time low, and by 2012, public confidence in banks was down to 21%, a nearly 40% drop in confidence from 1979 when the SEC first contemplated the accredited investor definition .[48] As a result, the public began increasingly participating in small business investment opportunities.[49] Middle-income and unsophisticated investors are now turning to securities investments to save for retirement.[50] This is the case even though the private securities market has traditionally been considered a riskier investment than real estate, and bonds. Despite the higher risks, some investors prefer private offerings because of the potential for higher return.[51]

The shift in the investment strategy of the public has shed light on the significance of private placements in today's economy. Today, there are just as many private offerings as there are public offerings.[52] To demonstrate, in 2013, issuers utilizing Rule 506 raised over $1 trillion, whereas issuers using public offerings raised $1.3 trillion. Much of this has to do with the fact that companies are remaining private for much longer than they were in 1980. With a drop in the number of early IPO issuances, private sourcing has become the predominant form of funding for

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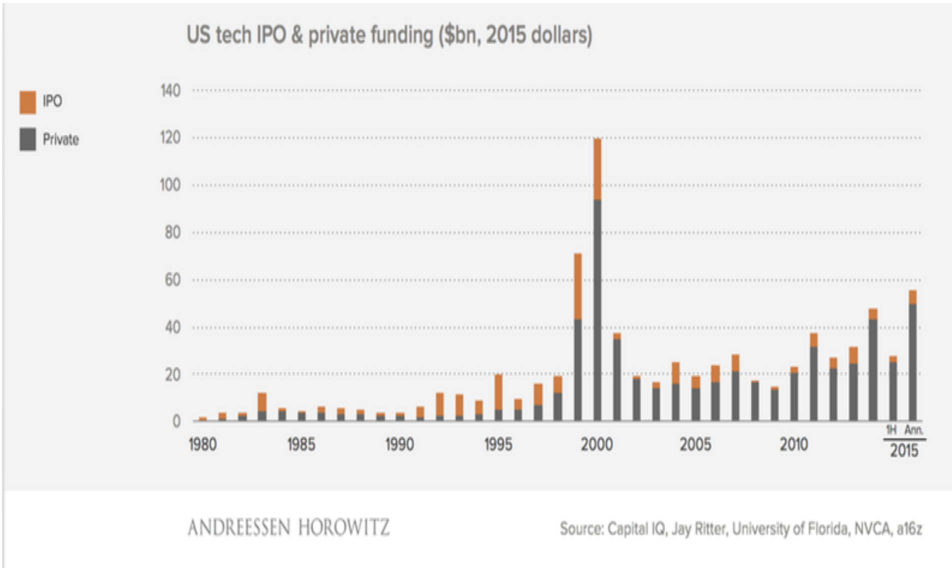
[48] Rebecca Riffkin, *In U.S., Confidence in Banks Remains Low*, ECONOMY (June 26, 2014), http://www.gallup.com/poll/171995/confidence-banks-remains-low.aspx
[49] *Id.*
[50] Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014)
[51] *See generally* Timothy B. Lee, *4 charts that show how today's tech boom is different from the 1990s*, Vox (Aug. 19, 2015)
[52] [52] Recommendation of the Investor Advisory Committee: Accredited Investor Definition, *supra* note 50.

emerging companies.[53] This chart demonstrates this trend as to technology companies, which most actively utilize the Rule 506 exemption:[54]



While the public can still invest in public securities, the reality is that private securities have a much greater potential for return. With companies remaining private for greater lengths of time, there is less potential upside in investments made after the company has gone public.[55] In contrast, investors involved from a company's inception have the potential for significant returns on their investments. For example, Peter Thiel, who invested in Facebook from its inception, turned his $500,000 investment into over $1 billion.[56] Unfortunately, the reality is that a majority of private offerings are completed using Rule 506, and although Rule 506 allows a limited number of non-accredited investors to invest in an offering, most companies limit private offerings to only accredited investors. For example, technology startups predominantly rely on rich investors rather

[53] Timothy B. Lee, *4 charts that show how today's tech boom is different from the 1990s*, Vox (Aug. 19, 2015)
[54] DERA Oct 27
[55] Recommendation of the Investor Advisory Committee: Accredited Investor Definition, *supra* note 50.
[56] Julianna Pepitone & Stacy Cowley, Facebook's First Big Investor Cashes Out, CNN Money (Aug. 20, 2012), http://money.cnn.com/2012/08/20/technology/facebook-peter-thiel/

than the general public to finance their growth.[57] Because most Americans do not meet the wealth requirements of Rule 506, they are unable to invest in companies like Facebook unless and until they are traded publicly. Therefore, by denying non-wealthy investors access to the most lucrative investment opportunities, Rule 506 discriminates against less wealthy prospective investors. Pursuant to Dodd-Frank, the SEC should adopt a rule that more effectively balances access to investment opportunities with investor protection.

III. Re-thinking Regulation D

Dodd-Frank's requirement that the SEC reconsider the accreditor investor standard has created a sense of urgency amongst institutional investors. Changing investment and regulatory trends compound the importance of a revision, and have promoted discourse within the financial industries community. Much of this discourse has taken place through comments submitted to the SEC. This Part will first reflect on what considerations the SEC should prioritize in establishing a new rule, and then consider the positives and drawbacks of some proposed approaches. This critical reflection demonstrates why the agency should incorporate a sophistication test to compliment a higher wealth requirement.

a. Considerations Essential to the Inquiry

In coming up with a new standard, the Commission should balance administrability against the underlying principles for the adoption of Regulation D. The exemption scheme under Rule 146, which preceded Rule 506, made it difficult for issuers to identify who actually qualified as an accredited investor. Consequently, administrability was a key consideration in the development of the current threshold, which utilizes an objective, bright line rule for issuers and investors. While an

[57] Timothy B. Lee, *4 charts that show how today's tech boom is different from the 1990s*, VOX, at 2 (Aug. 19, 2015)

objective rule is appealing, it does not fully capture everyone capable of making risky investments. With the adoption of Rule 508's safe harbor provision, which excuses issuances to non-accredited investors made in good faith, the SEC has more flexibility in adopting a subjective standard.

While Rule 508 allows for the incorporation of subjective components, the SEC should still develop a rule that issuers and regulatory bodies can easily apply. Therefore, the rule should possess an objective threshold. Failing to do so will result in the same problems that troubled Rule 146 and previous accreditation standards. The costs to the SEC in enforcing and clarifying grey areas of a complex rule can be costly.[58] Issuers may also be subject to litigation costs caused by unintended violations of the law. Even if Rule 508 excuses some of these transactions, the costs in justifying that one acted in good faith can still be considerable.[59] The threat of unexpected costs might also result in a problem prevalent with the current standard—although an issuer under Rule 506 can issue a security to 35 non-accredited investors, most issuers do not do so in practice because of the litigation and regulatory risks. Here, issuers might be deterred from selling securities to certain qualified investors simply because of the risks involved.[60]

The new rule should also protect investors. The rule should neither be overinclusive or underinclusive. If the rule is too lenient, investors that need the protection of the Securities Act might not receive it. This would negate the purpose of the Securities Act and the Court in *Ralston Purina*. If the rule is too strict, the same issues that affect the current standard will exist: qualified investors will not be able to access lucrative investment opportunities.

[58] SEC's Congressional Budget Report pp. 6, 15-16, https://www.sec.gov/about/reports/secfy16congbudgjust.pdf

[59] Seth Lipner, *Is Arbitration Really Cheaper*, FORBES.COM (July 14, 2009), http://www.forbes.com/2009/07/14/lipner-arbitration-litigation-intelligent-investing-cost.html

[60] *Life is Too Short to Deal with Non-Accredited Investors*, STARTUPLAWYER.COM (June 12, 2008), http://startuplawyer.com/seed-rounds/life-is-too-short-to-deal-with-non-accredited-investors

Finally, the new rule should encourage access to capital. Regulation D was adopted to promote economic growth and access to capital for small businesses.[61] Therefore, while investor protection and the adoption of a non-discriminatory rule are important, a new rule should encourage those ideals. Because many small businesses rely on Regulation D to raise capital, the standard should seek to either maintain or expand the number of qualifying investors. A rule limiting the number of qualifying investors could prove fatal to emerging companies forced to pay crippling registration and disclosure costs.

b. Flaws of the Current Standard

There is currently a debate about whether to maintain the current standard. Some industry professionals argue the standard is ineffective and outdated. Because the current standard is based on a financial wealth, it assumes that wealthy individuals can make better-informed investments than the rest of society. The standard presumes that wealthy persons have more personal investment knowledge, possess the resources to hire persons with the knowledge to effectively assess investment risks, and can better withstand the loss of a bad investment.

Others believe the current threshold should at the very least remain untouched. [62] The net worth qualification is deemed the most important criteria in ensuring investor protection and capital formation.[63] Individuals argue that for the past thirty years, the current standard has effectively allowed companies to raise capital while protecting investors. Limiting the amount of investors that

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[61] The SEC was correct in acting to protect the growth of emerging companies through Regulation D. Smaller companies play an important role in the U.S. economy today, creating a majority of new jobs and driving the U.S. economy.

[61] To illustrate, small businesses comprise 48.7 percent of private-sector employment and are responsible for about 63 percent of new jobs. Integral to the ability to grow is the ability of these small businesses to raise capital. Exempt offerings are now the predominant form of capital formation.

[62] http://www.angelcapitalassociation.org/blog/update-on-accredited-investor-definition-advisory-committee-passes-recommendations-sec-itself-hasnt-acted/

[63] GAO Alternative Criteria

qualify will substantially reduce the investment pool for companies. Furthermore, proponents argue increasing the net worth and income requirements would provide only a marginal increase to investor protection because most investors engage in due diligence when investing.[64] This is supported by a report by the SEC's Investment Advisory Committee, which notes that "[t]he connection between fraud and the current accredited investor thresholds seems tenuous at best."[65] The Committee was unaware of "any substantial evidence suggesting that the current definition of accredited investor has contributed to the ability of fraudsters to commit fraud or has resulted in greater exposure for potential victims."[66] This evaluation suggests that the current threshold protects investors from financial fraud, which is consistent with the goals of the Securities Act.

This proposition has been widely critiqued. The standard does not fully exclude persons who need the protection of the Securities Act, or more specifically people who can "fend for themselves." First, the standard over-simplifies factors necessary to determine "whether an individual has the wealth and liquidity to shoulder the potential risks of private offerings."[67] Because the wealth requirement has not been adjusted for inflation since 1982, the population that qualifies under the current standard is dramatically larger than initially intended. One million dollars in 1982 is the equivalent of $2.43 million dollars in 2015.[68] Furthermore, the average household income in 1982 was $20,170[69] as compared to $52,250 in 2015.[70] Thus, both of the eligibility requirements are

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[64] GAO

[65] Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014)

[66] *Id.*

[67] *Id.*

[68] Steven J. Choi, SECURITIES REGULATION CASES AND ANALYSIS 563 (4th ed. 2015).

[69] Edward J. Welniak & Mary F. Henson, Money Income of Households, Families, and Persons in the United States: 1982 (Feb. 1984).

[70] How much do Americans earn in 2015? A comprehensive look at household income and individual earnings. GDP disconnects from household income, http://www.mybudget360.com/how-much-do-americans-earn-in-2015-household-income-wages-real-income-gdp/

effectively half of what they were when Regulation D was enacted. While increased access to these investments is encouraged, access by unqualified investors undermines the goals of the Securities Act and Regulation D. A person with a net worth of $1,000,000, today, might not be able to bear the burden of loss from these high-risk investments.[71] The standard does not measure the liquidity of investors because it factors in assets like retirement savings and securities. Dodd-Frank addressed the problem by removing the value of a primary residence from the net worth calculation, which reduced qualifying investors by 25%.[72] This decision, however, did not address the full breadth of the problem. An individual's additional assets, the number of working years left, and investments in private offerings, retirement savings, and securities should also be considered. Therefore, the current standard fails to account for the ability of an investor to actually withstand the loss of an ill-fated investment.

Second, a wealth-based threshold does not adequately measure financial competency. $1,000,000 in net worth or $200,000 in yearly income will not necessarily give an individual more financial competency to evaluate investment risks than someone without that capital. The knowledge necessary to evaluate financial products is more extensive than it was when Regulation D was enacted in 1982. Financial instruments and investment forums are becoming more complex, and the new general solicitation rules will result in investment opportunities reaching more people. Thus, investors are more susceptible to fraud, purchasing overvalued securities, and miscalculating the value of certain investments.

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[71] Small Business Capital Formation – Consolidated 2013 forum recommendations
Mary Jo White: "While it is hoped that many small businesses will grow and flourish and make money for both entrepreneurs and investors, we should not lose sight of the heightened risks these riskier enterprises pose for investors—through the higher risk of small business failure, the lower liquidity of these securities, and, regretfully, the higher incidence of outright fraud in the small business security markets."

[72] Devin Thorpe, *SEC Mulls Changes to Accredited Investor Standards, 18 Crowdfunders React*, FORBES.COM (July 15. 2014), http://www.forbes.com/sites/devinthorpe/2014/07/15/sec-mulls-changes-to-accredited-investor-standards-18-crowdfunders-react/.

By catering solely to those who can financially withstand a loss, this threshold discriminates against certain sophisticated investors who can better evaluate the risks of a transaction. Some of the wealthiest individuals have low financial literacy.[73] A person able to financially bear the loss from a poor investment might not be able to evaluate the strengths and weaknesses of certain transactions. To illustrate this paradox, while someone like Paris Hilton can invest, on her own, in high-risk and complex securities, an industry professional with an advanced degree and technical experience did not meet the threshold will be prohibited in doing so. In short, the current standard is inadvertently overinclusive and underinclusive.

Taken together, it is clear that while there may be differences in thought as to where the financial threshold should be, the current standard should *at least* be adjusted to include persons with adequate financial sophistication to fend for themselves.

c. Approach in the United Kingdom

The current threshold should mirror some aspects of the U.K.'s requirements for equity investments. A comparison of the two approaches is logical considering the Securities Act was modeled after the U.K. Companies Act of the day.[74] Currently the Financial Conduct Authority (FCA), the English equivalent of the SEC, has utilized a wealth based and sophistication requirement.[75] The wealth-based threshold is similar to the current threshold of the United States, albeit lower with regards to the net worth standard. An individual making €100,000, or with a net worth of €250,000 (excluding primary residence) can invest in certain private equity-based

[73] Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014).

[74] George J. Benston, review, Tim Bush, *"Divided by Common Language," Where Economics Meets the Law: US versus non-US Financial Reporting Models*, 83 THE ACCOUNTING REV. 549, 549 (2008).

[75] Anthony Zeoli, *Changes to "Accredited Investor" Definition Could Clip the Wings of Angel Investors*, CROWDFUND INSIDER (June 19, 2014), http://www.crowdfundinsider.com/2014/06/42279-changes-accredited-investor-definition-clip-wings-angel-investors/.

investments.[76] Further, an investor can qualify under the sophistication qualification by taking an exam tailored by the issuer based on the specific investment and associated risks, or by using self-certification.[77] Under this approach, not only has the private placement industry grown tremendously, but there has been an almost "non-existent rate of investor fraud."[78] Therefore, in thinking about the new definition, this standard can serve as guidance.

d. Adjusting The Threshold For Inflation

The SEC should adjust the current financial threshold for inflation to better identify those who can withstand a loss and understand investment risks. Certain industry specialists affirm this sentiment. Only three percent of investors, as opposed to the 7.4 percent of investors that currently qualify, will be considered accredited investors if the threshold is adjusted.[79] An adjustment would thereby eliminate sixty percent of currently eligible investors.

Faced with these statistics, angel investors are advocating keeping the current threshold in place. At least one fourth of angel investors will no longer qualify if the threshold is adjusted for inflation. Concerned with the impact on small businesses, these investors argue that a heightened threshold will deny emerging companies access to capital formation. This financial burden is compounded by the strict registration and disclosure requirements of the Securities Act. Not only are the private and public markets comparative in size, but companies are increasingly relying on exemptions in the early-stages of formation. With these concerns in mind, in 2015, the Advisory

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[76] http://www.crowdfundinsider.com/2014/06/42279-changes-accredited-investor-definition-clip-wings-angel-investors/
[77] *Id.*
[78] *Id.*
[79] Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014).

Committee on Small and Emerging Companies recommended that any changes to the definition should expand the number of persons eligible as accredited investors.[80]

These concerns are valid, but neglect the purpose of the investor accreditation standards: to protect investors who cannot fend for themselves. As noted above, wealth does not necessarily equal financial literacy, and the standards no longer measure who can financially withstand a poor investment. Increasing the threshold will remedy these weaknesses. Furthermore, the SEC can adjust the threshold while still increasing the number of qualifying investors simply by adopting a supplementary means of qualification, discussed below.

Furthermore, as illustrated above, the existence of higher qualifying thresholds in similar statutes illustrates that the SEC should adjust this threshold for inflation. Under the Investment Company Act of 1940, if a private fund has over one hundred investors, all of the investors must be "qualified purchasers" to be exempt under 3(c)(7). A natural person must have no less than five million dollars in investments to be considered a qualified purchaser. Under the Advisers Act, if a fund manager is registered with the SEC, the fund's clients must all be "qualified clients" for the fund manager to receive performance-based compensation. A person is considered a qualified client when he or she has more than $1.5 million dollars in assets.

Overall, the current wealth-based threshold should be adjusted for inflation to better comport with the protections of the Securities Act, and identify the class of persons Regulation D intended to exclude.

e. **Incorporating a Sophistication Test**

Having determined that the current standard should be adjusted for inflation, the SEC should consider supplementing the wealth standard with a sophistication standard. Doing so would better identify individuals that can evaluate investment risks, while promoting access to capital for

[80] Advisory Committee Recommendation (2015 March 5).

small businesses. The challenge is devising a test that adequately identifies a sophisticated investor. So far, different criteria have been suggested, including an experience-based model, certain financial securities licenses, academic accomplishments, and an exam.[81] We will consider each of these in turn.

1. **Experience-Based Model**

Professional experience is one indicator of a sophisticated investor. Proponents of an experience-based model suggest individuals with certain professional credentials should qualify as accredited investors because they can better evaluate investment risks.[82] The difficulty with the experience-based model is ascertaining which experiences reflect adequate investor sophistication, especially because different investment considerations apply to offerings in different industries. Some proponents offer the Series 7 license and Chartered Financial Analyst designation as a guidepost.[83] A Series 7, General Securities Representative, exam tests the competency of a general representative in selling securities.[84] Because a person that passes this exam can sell securities to the public, he or she should be able to invest his or her money in those same securities. While a Series 7 license or a Chartered Financial Analyst designation can indicate financial sophistication, not everyone capable of investing in private offerings would be covered by a sophistication test based solely on these qualifications. For example, a Series 7 license is only available to persons sponsored by a member firm of either FINRA or a self-regulatory organization, which is not the case for every

[81] During the SEC's Small Business Capital Formation Forum in 2013, a breakout group asked the Commission to "consider additional separate categories of qualification for accredited investors based upon passing an SEC-approved examination, or based upon various types of sophistication, such as education, experience or training, including, without limitation, persons holding FINRA licenses, or CPA or CFA designations." Small Business Capital Formation – Consolidated 2013 forum recommendations.
[82] Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014)
[83] *Id.*
[84] http://www.finra.org/industry/series7.

sophisticated investor. Therefore, other financial industry professionals should also qualify under the accreditation standard.

Investment experience can also indicate financial sophistication.[85] An individual's securities portfolio, or membership in an angel group or similar investment group, is a relevant consideration. This standard, by itself, is difficult to implement and regulate, and issuers are at greater risk for liability because of the difficulty of ascertaining sophistication on these qualifiers alone. For example, an angel group member can still be unqualified to evaluate an investment risk of certain offerings. Furthermore, an individual with a diverse or even successful investment portfolio might not be financially sophisticated as luck, advice, and other external factors might have contributed to his or her holdings.

2. **Education Based Model**

An individual's educational credentials can indicate financial sophistication. If the definition of an accredited investor were to include an education-based threshold, certain credentials would serve as automatic qualifiers. While this approach is easily administrable, it is problematic for many reasons. First, it is not clear what degrees should qualify under the standard. For example, a labor and employment attorney would likely lack the requisite experience to invest in a technology start-up. The same goes for persons with PhDs and Masters. None of these degrees, even if related to financial industries, would guarantee that an individual could evaluate the risks associated with securities in specific industries. A person with an Economics PhD could have focused on a niche area of economics such as development economics. Therefore, like the wealth standard, this standard by itself could be underinclusive and overinclusive, and would not be the most effective way of ensuring that an investor can competently evaluate the strengths and weaknesses of a security.

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[85] Release No. 33-8828: IC-27922: File No. S7-17-07.

3. A Financial Sophistication Test

While both the professional and academic experience models provide potential methods of determining investor sophistication, an ideal gauge of financial sophistication would incorporate different components of each test. For this reason, some have advocated for the administration of a third-party test to determine whether someone qualifies as an accredited investor. Ideally, this test will be approved and monitored by the SEC or FINRA

The underlying goals of such a test would be administrability, accuracy, cost-effectiveness, and fairness. While the test should accurately identify as many sophisticated investors as possible, the questions on the exam should be straightforward to avoid over-burdening the administering entity. One of the appeals of the current wealth-based standard is that it is easily administrable and easy to regulate. The more complex the test, the more difficult it will be for regulators to identify sophisticated investors. Even though an exam that evaluates the totality of each investors experience would be ideal, such an exam would be costly for the government, and a likely somewhat inaccurate predicator for sophistication. It goes without saying that federal agencies are already overburdened with work, and funding for such an exam would be difficult to procure. Also, the time spent evaluating the inevitable flood of exams could be better spent addressing other impacting issues. Furthermore, the review process might produce arbitrary results. The outcome of an individual application could depend on the individual reviewing the application, which could result in different results between equal applicants.

f. My Proposal

After examining the above approaches, I recommend the SEC adjust the wealth component for inflation, and incorporate a financial sophistication test. Adjusting the threshold for inflation would ensure that only people that can withstand the loss of a bad investment would qualify, but a sophistication test would recapture those capable of evaluating faulty investments excluded by the heightened threshold. The SEC should partner with FINRA, which has a proven track record of administering numerous examinations, such as the Series 7 exam discussed above, meaning that relevant administrative bureaucracy and processes are already in place.[86] Costs would be limited because only a motivated, self-selecting group of people who did not qualify based on the adjusted wealth threshold would take the test; and because reasonable fees similar to those in place for existing FINRA exams would be assessed.[87]To address any concerns regarding a sophisticated investor's ability to withstand a loss, the SEC could incorporate an additional limit to how much an individual can invest in securities based on net worth or annual income—similar to the crowdfunding limitations.[88] Overall, this new standard would accommodate some of the concerns of angel investors and small businesses, while comporting with the goals of the Securities Act and Regulation D—protecting investors and promoting small business capital formation.

E. CONCLUSION

Dodd-Frank's requirement that the SEC reconsider the definition of an accredited investor for natural persons indicates that the current standard is no longer adequate for today's investment landscape. In analyzing the impacts of the standard, it is clear that it no longer adequately protects the interests served by the Securities Act. My proposal would likely comport with the interests of the Securities Act, Regulation D, and the investment landscape. Adjusting the threshold for inflation ensures that investors meeting the financial threshold can both withstand a loss and retain the services of an individual capable of analyzing a risky security. Furthermore, a sophistication test

[86] http://www.finra.org/industry/qualification-exams
[87] *Id.*
[88] Under the new crowdfunding regulations, if an individual's net worth or annual income is less than $100,000, an investor may invest the greater of $2,000 or 5% of the lesser of his or her net worth or annual income. However, if both net worth and annual income are greater than $100,000, an investor may invest up to 10% of the lesser of his or her annual income or net worth. Brian Burt et. al, *What in House Attorneys Need to Know about* Crowdfunding, LAW.COM, //www.law.com/sites/articles/2016/02/26/what-in-house-attorneys-need-to-know-about-crowdfunding/#ixzz43NfiJvtL

would allow persons with the financial acumen to fend for themselves to invest in high-risk, high-return securities despite not meeting the financial thresholds. While heightening the financial threshold would eliminate a large percentage of persons that currently qualify, the sophistication test would recapture those capable of making these investments. Therefore, while small businesses might suffer a loss, it is not clear any loss would be significantly deleterious to capital formation because a sophistication test will open the gates for investors able and willing to participate in private placements notwithstanding less extensive wealth. In addition, companies would retain the option of going public to pursue further investors. Ultimately, the SEC should heighten the financial threshold and adopt a financial sophistication exam to best address the concerns of both regulators and investors.