



Virginia Law Review Association
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January 13, 2020

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule Amending the “Accredited Investor” Definition (File No. S7-25-19)

Dear Ms. Countryman,

My name is Blake Delaplane and I am writing in my capacity as a law student at the University of Virginia School of Law and member of the Editorial Board of the Virginia Law Review.¹ I firmly support the Commission’s attempts to provide additional ways in which a natural person might qualify as an accredited investor. While the release represents a move in the right direction for democratizing exempt offerings, I respectfully submit that the Commission should make its rationale more compelling for certain proposed amendments to the accredited investor definition. In order to ensure the accredited investor definition is consistent with the function the Commission detailed in its 1987 rulemaking release, it should do the following:

1. Clarify how it is interpreting the 1987 accredited investor intent language in connection with its sophistication certifications or designations proposal to legitimate the proposed accredited investor standard or
2. Eliminate qualifying solely on the basis of the income or net worth financial thresholds. Instead, in addition to adjusting the financial thresholds for inflation, require that the accredited investor maintains some measure of financial sophistication by requiring that *all prospective investors* take an SEC-issued accredited licensing exam. If they pass, subject each investor to an investment limit proportional to their income or net worth so as to equal the relative investment opportunity among all natural persons qualifying as accredited investors.

¹ The views expressed herein are entirely the author’s and do represent the views of the Virginia Law Review Association.

A. Clarifying how to Interpret the 1987 Intent Language of the Accredited Investor Definition

The Commission begins its proposed rule changes by prefacing its proposed changes with language from its Regulation D *revisions* release in 1987. In that release, the Commission undergirded its determination of which factors to consult in evaluating accredited status by identifying those investors “whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act’s registration process unnecessary.”² Trouble arises from the fact that this intent language remains unclear. There are two legitimate options for interpreting the language. But each option poses distinct consequences for how the accredited investor standard operates. Clarification is sorely needed in any future adopting release to ensure consistency behind any measures the Commission uses to qualify natural persons as accredited.

1. Interpretative Option A

A strict reading of this intent language suggests that the accredited investor definition need not contain factors solely meant to judge an investors “ability to sustain the risk of loss of investment.”³ Instead, the Commission could find an investor to have sufficient financial sophistication to “render the protections of the [’33 Act’s] registration process unnecessary” provided that such sophistication qualifies the investor as able to fend for themselves. While financial sophistication is a necessary component of an accredited investor’s profile, the 1987 intent language reveals it is not alone sufficient for meeting the definition. Being accredited, according to the Commission, requires both financial sophistication and (1) investment loss capacity *or* (2) ability to fend for themselves. If the Commission is willing to grant an investor accredited status despite them not meeting the income or net worth thresholds, the investor must be both sufficiently financially sophisticated *and* able to fend for themselves. With this reading of the 1987 intent language, the Commission should elaborate in any future adopting release that the disjunctive mechanic supports expanding the pool of natural accredited investors beyond mainly just income or net worth thresholds.

This interpretation does, however, generate problems. In adopting this reading of the intent language, the Commission appears to have implicitly amended its 1987 determination of

² *Amending the Accredited Investor Definition*, SEC Release No. 33-10734, at 16 (Dec. 18, 2019), <https://www.sec.gov/rules/proposed/2019/33-10734.pdf> [hereinafter 2019 Proposing Release] (quoting *Regulation D Revisions; Exemption for Certain Employee Benefit Plans*, 52 Fed. Reg. 3015, 3017 (Jan. 16, 1987) [hereinafter Regulation D 1987 Proposing Release]); see also *Concept Release on Harmonization of Securities Offering Exemptions*, 84 Fed. Reg. 30,460, 30,470 (June 18, 2019); SEC Staff, *Report on the Review of the Definition of “Accredited Investor”* 17 (Dec. 18, 2015), <https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf>; *Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A)*, 80 Fed. Reg. 21,805, 21,816 n.146 (Mar. 25, 2015).

³ The fact that the second prong is disjunctive (*i.e.*, an investor who meets the financial sophistication requirement only needs to show they are *either* able to sustain the risk of loss of investment *or* able to fend for themselves) allows an investor to meet the intent of the accredited standard without meeting financial thresholds. See *United States v. Woods*, 571 U.S. 31, 45 (2013) (noting how “or” is “almost always disjunctive”).

what constitutes an accredited investor. At first glance, the accredited investor definition prior to the Commission’s December 2019 rule proposal violated its 1987 guidance. Nowhere in the accredited investor definition does the Commission require that an investor meeting the financial thresholds also be financially sophisticated.

The present proposal also undermines the Commission’s 1987 guidance. The Commission has offered to expand the natural person accredited investor pool on the basis of financial sophistication alone, without addressing whether those qualifying investors also can fend for themselves. According to the current accredited investor definition, a natural person investor meeting the proposed financial sophistication threshold does not have to also demonstrate “ability to sustain the risk of loss of investment” nor do they have to *separately* demonstrate an ability to fend for themselves. Instead, the Commission implies that meeting that first prong of being sufficiently financially sophisticated is controlling. A future release should resolve the misalignment between the way the intent language might be read and how the accredited standard operates in real time. To achieve this realignment, the Commission must return to *Ralston* to assess what it means to be able to fend for oneself *in addition to* being financially sophisticated.

Indeed, the proposing release takes some steps to connect the element of financial sophistication with satisfying the *Ralston* rubric; but the Commission must go further. Notably, the proposing release explicitly affirms that knowledgeable employees of private funds would be both sufficiently financially sophisticated and able to fend for themselves—satisfying both elements of the 1987 framework.⁴ But the Commission ought to also clarify that investors with SEC-approved financial credentials demonstrate sufficient financial sophistication *and* the ability to fend for themselves in accordance with the 1987 intent language. The crux of that determination hinges on the request for comment in the release. There the Commission asks whether holding one of the preliminarily approved certifications is enough on its own to merit accredited investor status. If the Commission finds that financial sophistication is sufficient for establishing that an investor is able to fend for themselves, then attaining one of the preliminarily approved certifications should merit accredited investor status.

The question remains unsettled: Does an investor meeting the financial sophistication standards expected of an accredited investor also prove to be able to fend for themselves, despite not meeting the income or net worth thresholds? The Commission includes the caveat that an investor holding one of the appropriate financial certifications or designations *may not* need the protections of registration under the Securities Act.⁵ In other words, they *may* be able to fend for themselves. Perhaps the Commission’s noncommittal language is a reference to its subsequent determination that “an inactive certification, designation, or license, particularly when the

⁴ 2019 Proposing Release at 43 (“We believe that such employees, through their knowledge and active participation of the investment activities of the private fund, are likely to be financially sophisticated and capable of fending for themselves in evaluating investments in such private funds.”)

⁵ *Id.* at 30 (“[I]ndividuals who have passed the necessary examinations and received their certifications or designations described above have demonstrated a level of sophistication in the areas of securities and investing such that they *may not* need the protections of registration under the Securities Act.” (emphasis added))

certification or designation has been inactive for an extended period of time, could lessen the validity of the certification or designation as a measure of financial sophistication.”⁶ Regardless, any future adopting release should make clear that insofar as one’s certification or designation remains active, they have also proved to be able to fend for themselves. That determination would uphold the Commission’s 1987 intent construct under the first interpretive approach.

2. *Interpretative Option B*

The Commission could make the more convincing argument that the disjunctive particle in the 1987 intent language separates fending for oneself from the preceding two elements—financial sophistication and the ability to sustain the risk of loss of investment. If they fail either prong, they would only be able to still qualify as accredited if they separately demonstrated the ability to fend for themselves. This interpretation makes sense considering the current accredited investor definition incorporates a member of the executive team of the issuer in whose exempt offering the investor is seeking to invest, even if that investor does not meet the income or net worth requirements.

Furthermore, the Commission should seek the blessing of the *Ralston* doctrine by clarifying that meeting both the financial sophistication and ability to sustain the risk of loss elements certifies that an investor is able to fend for themselves. In failing to make that explicit, the Commission risks leading the public to believe that meeting the *Ralston* standard is not wholly necessary to becoming an accredited investor.

Endorsing this interpretation comes with strings attached. The Commission must pair investment limits with those investors who hold the preliminarily approved professional certifications or designations since those metrics speak only to an investor’s financial sophistication, not to their ability to sustain the risk of loss of an investment. And if the Commission decides to impose investment limits for these investors, it should apply a cap that is no more restrictive than the 10% limit in Tier 2 Regulation A offerings. Because these investors can demonstrate financial sophistication—a finding that is not guaranteed among the non-accredited investors in Tier 2 Regulation A offerings—the Commission would have reason to increase the investment limit beyond 10% of the greater of income or net worth.

In separating the 1987 intent language’s first two factors from the ability to fend for oneself, the Commission should, however, address the inadequacy of the income and net worth financial thresholds already in place. Nowhere in the 1987 language does one get the sense that financial sophistication is in some way less important than the ability to sustain the risk of loss of investment. If the Commission were to apply investment limits to those who meet the proposed financial sophistication criteria, those investors qualifying on the income or net worth thresholds alone would not align with the 1987 intent language. As discussed by previous commenters, those thresholds do not capture a pool of natural person investors who are entirely financially sophisticated. Instead, such thresholds act as a qualification shortcut—allowing in accredited investors who are able to sustain the risk of a loss in the investment *but who are not necessarily*

⁶ *Id.* at 32–33.

financially sophisticated. Ultimately, the Commission implies that meeting the financial thresholds automatically cause the natural person investor to also be deemed sufficiently financially sophisticated.⁷ If that is the case, why does the Commission not also assume the reverse—that those who hold a Series 7 are sufficiently likely to be able to sustain the risk of loss of investment?

Applying investment limits to those investors qualifying on grounds other than the income or net worth thresholds presents the Commission with an opportunity to implement a standard that actually aligns with the 1987 intent language. In making such amendment, the adopting release should also explain how it squares its rationale (that accredited investors are those who are both financially sophisticated and have the ability to sustain the risk of loss of investment) with qualifying solely on the basis of income or net worth.

Regardless of which interpretation the Commission selects, it must recognize that the proposing release leaves material explanatory gaps between the intent behind the accredited investor definition and the measures it selects to execute on that intent. Explicitly addressing such gaps will enhance the legitimacy of the accredited investor standard.

B. Pairing a Financial Sophistication Requirement with Investment Thresholds that are Adjusted for Inflation

Alternatively, the Commission should consider removing accredited status for all those who qualify on the basis of financial thresholds but who cannot show sufficient financial sophistication. In the proposing release, the Commission elected not to adjust the financial thresholds for inflation.⁸ Following the inclusion of joint spousal income in 1988, the

⁷ *Id.* at 75 (“We believe that the current wealth-based criteria are useful for the identification of investors who do not require the protections afforded by registration.”); *but see, e.g., id.* at 55 n.148 (acknowledging 2016 NASAA Letter (“An investments test is a better gauge of financial sophistication than simply analyzing net worth or income”)).

⁸ Since first studying the issue as it related to the retailization of hedge funds in the Staff’s 2003 report to the Commission, lawmakers and regulators continue to dance around the issue. *See* 156 Cong. Rec. S3813 (daily ed. May 17, 2010) (statement of Sen. Dodd) (emphasizing, in a proposed but failed amendment to the Section 413(a) of Dodd-Frank, an update to the income and net worth thresholds in light of the fact that such amounts “have not been changed since 1982”); *Net Worth Standard for Accredited Investors*, 76 Fed. Reg. 81,793 (adopted Dec. 21, 2011) (no mention of inflationary adjustments despite adopting amendments to the net worth calculation of the accredited investor definition); *Revisions of Limited Offering Exemptions in Regulation D*, 72 Fed. Reg. 45,116, 45,126 (proposed Aug. 3, 2007) (proposing “to adjust for inflation all dollar-amount thresholds in Rule 501(a) of Regulation D on a going forward basis, starting on July 1, 2012, and every five years thereafter” but expressing concern over the possibility that issuers forego using Regulation D because it restricts the pool of available investors in an offering); *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, 72 Fed. Reg. 400, 406 (proposed Dec. 27, 2006) (proposing a new “accredited natural person” definition applicable to a select few private offerings that would require the investor meet both the 501(a) accredited standard and own at least \$2.5 million in investments which would be adjusted for inflation every five years on an ongoing basis beginning on April 1, 2012); Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* 80 (2003), <https://www.sec.gov/news/studies/hedgefunds0903.pdf> (observing that “inflation, along with the sustained growth in wealth and income of the 1990s has boosted a substantial number of investors past the ‘accredited investor’ standard”).

Commission determined that 6.8 million or 7.3% of households met the financial thresholds while, in 2019, 16.0 million or 13.0% qualify.⁹ Income and net worth measures, without more, are inappropriately tailored to achieve the intent of the accredited investor standard—identifying those who are sufficiently financially sophisticated and have the capacity to sustain the risk of loss of investment or fend for themselves.

1. Inflation Adjustments Should be Made to the Financial Thresholds

Because the Commission decided against indexing the accredited investor financial thresholds for inflation in the proposing release, it has weakened its justification for singlehandedly using income and net worth thresholds. By not adjusting the thresholds for inflation, the Commission has lowered—over time—the required ability to sustain the risk of loss of investment expected of natural person investors in many exempt private offerings. At one level this is consistent with the Commission’s overall push to widen the accredited investor pool into the future. Yet such a move downplays the degree to which an investor ought to be able to sustain the risk of loss of their investment in an exempt offering.

It is imperative that the Commission retain its principled commitment to identifying investors who are able to fend for themselves but also be willing to amend or eliminate certain past characteristics it has used to make these determinations. The Commission’s research, analysis, and public interaction through its advisory committees and forums has helped the Commission better identify how to measure the financial sophistication of investors. If income and net worth do act as sufficient proxies for financial sophistication, one would expect the Commission to upkeep their sorting tendency among the natural person investor population in America. This reasoning of course assumes that the accredited standard represents some constant, unchanging level of financial sophistication expected of accredited investors. Opening the accredited pool to more investors does not *in sui* lower the level of sophistication expected of an accredited investor. Rather, tweaking preexisting metrics of sophistication is indicative of changing the level of sophistication expected of an accredited investor.¹⁰ The Commission considers “wealth-based criteria ... useful for the identification of investors who do not require the protections afforded by registration.”¹¹ Therefore, by leaving the financial thresholds

⁹ 2019 Proposing Release, *supra* note 2, at 77, Table 4.

¹⁰ The Commission’s justification for not indexing for inflation its financial thresholds rests on the egalitarian attempt to not ostracize investors in less affluent communities from being able to invest in exempt private offerings. *Id.* at 80. However, providing additional measures that are more narrowly tailored to identifying the core level of sophistication expected of an accredited investor—such as through certain professional certifications and designations—will better ensure that these investors are indeed suitable participants in exempt private offerings. Despite its citation to a recent study on the effect of eliminating primary residence from net worth calculations for natural person investors, the Commission assumes such financial measures, on their own, are appropriate for filtering investors into and out of the accredited pool. *Id.* at 106 n.263 (citing to Laura Lindsey & Luke C.D. Stein, *Angels, Entrepreneurship, and Employment Dynamics: Evidence from Investor Accreditation Rules* (Working Paper, 2019)).

¹¹ *Id.* at 75; *see also* U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-640, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED 8 (2013), <https://www.gao.gov/assets/660/655963.pdf> (“The income and net worth thresholds established in Regulation D were intended to serve as proxies for financial experience, sophistication, and adequate bargaining power.”).

wooden, the Commission has implied that the level of sophistication expected of an accredited investor has in fact lowered since the standard's adoption.

2. *Designing an SEC-Issued Accredited Investor Licensing Exam Paired with Investment Limits*

Therefore the Commission ought to require that those meeting the financial thresholds display some semblance of financial sophistication to better ensure that, even with a showing of sufficient capacity to sustain the risk of loss of investment, the investor also displays the 1987 construct's first requirement: financial sophistication. This reform could most easily be met by requiring all investors seeking to participate in an exempt offering as an accredited investor to have passed an SEC-issued accredited investor licensing exam. In addition, natural person accredited investors would be capped on their investment based on their income or net worth to ensure an equal playing field for all natural persons qualifying as accredited investors.¹²

Very truly yours,

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¹² If the SEC were to issue its own accredited investor licensing exam and require all investors to pass it, the income and net worth test would be unavailing. By including an investment limit for all natural person investors in conjunction with having passed the accredited investor licensing exam, all investors would be guaranteed to meet the two prongs of the 1987 construct.

