

VIA E-MAIL SUBMISSION

March 6, 2020

Ms. Vanessa A. Countryman
Secretary of the Securities and Exchange Commission
Three Lafayette Centre
100 F Street, NE,
Washington, DC 20549-1090.

Re: Release Nos. 33-10734; 34-87784; File No. S7-25-19: Amending the “Accredited Investor” Definition

Dear Ms. Countryman:

This letter is authored by an upper level student at the Hofstra University Maurice A. Deane School of Law. The author’s exposure to the realm of securities law has led to pertinent research into this topic as it relates to accredited investors.¹ I thus appreciate the opportunity to comment on an issue that will have a significant impact on the securities markets as well as those whom regulate it.

This Comment Letter represents the author’s attempt at harmonizing the accredited investor definition with the policy grounds for which exemptions in our regulatory system exist and penultimately, the reason the 73rd Congress enacted the Securities Act of 1933 (“Securities Act” or “’33 Act”) and the Securities and Exchange Act of 1934 (“Exchange Act” or “’34 Act”).

Although this Comment Letter does not seek to answer every question proposed by the Securities and Exchange Commission (“SEC” or the “Commission”), the author feels strongly that the “Adding Categories of Natural Persons Who Qualify as Accredited Investors,” specifically “Professional Certifications and Designations and Other Credentials” section should form the crux of this Comment Letter due to the inherent and significant implications it will have on a vast scale.

As a global theme to be presented throughout this Letter, the author feels that a hybrid of expanding and contracting the accredited investor definition, as applied to individuals, is particularly warranted due to the uninhibited availability of information to the general public in today’s technological world as well as vast improvements in education and regulatory barriers in entering the field of securities, thus improving protections to those who need it most. Included in this theme, the author feels that the current monetary threshold is insufficient to protect potential investors due to the increased rate of inflation; consequently, allowing more unsophisticated investors to achieve the status of an accredited investor.

¹ The author first attended Fairfield University where he majored in Business Management and minored in Business Law, Ethics, and Regulations. The author has now delved into the legal ramifications of business and law during his studies at the Hofstra University Maurice A. Deane School of Law. During his educational training thus far, he interned for the Honorable Paul A. Crotty in the Southern District of New York where he had direct and immediate exposure to securities litigation. Currently, the author serves as a member of the *Hofstra Law Review* and has taken courses in Business Organizations, Private Equity, and, most pertinent, Securities Regulation which is taught by a former 10-year regulator. All views expressed herein are purely personal to the author.

The author feels that an educational component in conjunction with an increased monetary threshold will wholly achieve the goals of including an accredited definition in the first instance as well as satisfying the objectives of both the Securities Act and the Exchange Act.

This Comment Letter will thus proceed in two major parts: 1) evaluating the correlation between an individual's wealth and sophistication, and 2) comments on a licensing system to harmonize the accredited investor definition.

I. Wealth as a Nexus for Sophistication

The accredited investor definition plays a major role in both the exemption framework as well as aiding in capital formation.² It is “intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.” The Commission, in its Proposal, articulates various characteristics that would satisfactorily demonstrate one’s sophistication under this definition. These include the ability to assess an investment opportunity—meaning that one has the ability to analyze the risks and rewards of the potential investment, the financial capacity to diversify their portfolio as to mitigate or avoid risk of unsustainable loss, or the means to obtain pertinent information about the issuer and the potential investment opportunity—or the ability to bear the risk of a loss.

Under the current accredited investor definition, pure financial means is the only hurdle an individual must clear in order to achieve the status of an accredited investor and thus revoking the protections of the securities laws as applied to the individual in private offerings. However, the characteristics outlined by the Commission in determining sophistication all inherently include an educational component. It is hard to reconcile the idea that achieving a certain level of wealth automatically certifies an individual as having enough financial knowledge and sophistication in investment strategies and opportunities as to obviate the protections of the securities laws.³ To emphasize this point, as the author’s Securities Regulation Professor⁴ aptly put it, if you were to go to a Yankee game and enter their dugout, every single player sitting on that bench would qualify

² “In 2018, the estimated amount of capital (including both equity and debt) reported as being raised in Rule 506 offerings was \$1.7 trillion, compared to \$1.4 trillion raised in registered offerings.” SEC Proposal “*Amending the Accredited Investor Definition*” Release Nos. 33-10734; 34-87784; File No. S7-25-19 (December 18, 2019).

³ As reported by the SEC’s Division of Economics and Risk Analysis in 2010, many investors who achieve “accredited investor” status pursuant to wealth end up having limited experience investing in the securities market. *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC Release No. 33-9415, at p. 75 (July 10, 2013), available at <http://www.sec.gov/rules/final/2013/33-9415.pdf> (stating that “evidence suggests that only a small fraction of the total accredited investor population has significant levels of direct stockholdings.”). Other studies have shown that financial wealth and intelligence are not necessarily correlated. See Jay L. Zagorsky, *Do you have to be smart to be rich? The impact of IQ on wealth, income and financial distress, Intelligence* (2007) (finding that while income and IQ scores are related, there is no correlation between IQ scores and overall wealth). Furthermore, as one financial expert put it, “there are often people whose net worth puts them in the accredited category. They may be smart and successful in their fields, but most are confused about the basics of investing and managing money.” John E. Girouard, *The Sophisticated Investor Farce*, *Forbes* (Mar. 24, 2009), available at <http://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html?partner=contextstory>.

⁴ Professor J. Scott. Colesanti, Professor of Legal Writing and Securities Regulation at the Hofstra University Maurice A. Deane School of Law. Professor Colesanti has taught *Securities Regulation* every year since the year 2000 and served as a regulator for 10 years.

as an accredited investor yet the player's expertise in financial markets and investments most likely does not span further than any other individual in the stands who does not come close to meeting the financial requirement.

Maintaining a purely financial nexus to sophistication so as to qualify as an accredited investor overlooks major concerns. First, the definition may overestimate the financial capabilities of the wealthy. The current definition presumes qualifying accredited investors have either access to or the economic stature to obtain the material information necessary to make an informed risk-reward analysis of a potential investment, as well as the ability to secure competent investment advice from a licensed professional. Furthermore, many who reach the qualifying financial benchmark are those who inherit exorbitant amounts of wealth as well as lottery winners—some of which have no pertinent knowledge of investing nor do they have the knowledge to procure capable and trustworthy financial advice.

Second, because wealthy individuals often do not comprehend the significance of obtaining access to material information pertaining to the potential investment opportunity nor do they have the financial sophistication to understand the ramifications of not procuring it, many wealthy individuals frequently fail to seek advice from a licensed professional, especially if they are focusing on the immediate tax consequences of an investment as many individuals do.

Third, the excess of a \$1,000,000 net worth threshold or an excess of a \$200,000 annual income for the past two years for an individual or joint income with the individual's spouse or spousal equivalent in excess of \$300,000 in each of those years do not assure that, in fact, the investor is able to bear the risk of losing the invested funds. Illustrative of this is point is the possibility that an investor, who is accredited solely the basis of income, is insolvent at the time of purchase of the security. There is no requirement that the individual has a monetary reserve of the amount at the time of investment, simply that the investor have reached that level of financial wealth which would not adequately protect the individual if their investment fails.

Finally, these financial thresholds do not account for inflation. Without adjusting the initial income and net worth requirements, they are now effectively less than half of their original amounts, allowing an ever-expanding group of individuals to qualify as accredited investors, most of which have no pertinent knowledge regarding investments and financial markets. With the value of the dollar decreasing every day, more and more individuals with a deficiency of knowledge in investing in risky private offerings are now legally qualified to do so and are no longer afforded the protections of the securities laws under this exemption.⁵ The author thus feels that the wealth requirements must be increased to comport with the increased rate of inflation.

The author feels that the sole nexus between wealth and financial sophistication is insufficient to achieve the goals and objectives of the accredited investor definition. Therefore, the author proposes that there be an educational component introduced into the definition so as to ensure financial sophistication as well as including a monetary requirement which is corrected to comport with inflation.

⁵ Christopher R. Zimmerman, *Accredited Investors: A Need For Increased Protections in Private Offerings*, 114 NWU L. REV. 507, 522 (2019) (“When the definition was first introduced, only 1.5 million households, or 1.8% of households nationwide, qualified. Today that number has grown to over 16 million, or 13% of households.”).

II. Professional Certifications and Designations and Other Credentials

The financial ability to bear the risk of a loss is only half of the equation when it comes to investing in an ever so volatile securities market, especially a less regulated one. Yet, Regulation D sets forth no requirement that purchasers, whether accredited or nonaccredited, be able to bear the economic risks of an investment in the exempted offering. Under its definitional authority, Section 2(a)(15)(ii) of the 1933 Act, the Commission is required to make considerations of “financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management,”⁶ in determining which persons may be deemed accredited. As the definition is currently implemented however, only net worth and annual income serves as the basis of accreditation status.

This is why the author feels strongly that there should be an educational component included in the definition of an accredited investor. Requiring that an individual obtain a Commission approved certification or designation as it pertains to the securities market emphasizes an individual’s sophistication and unambiguously quantifies it. By having an educational component in conjunction with a monetary component, we achieve both objectives of the definition. First, it ensures that an individual is sophisticated enough to fully understand the potential risks they are taking when making an investment in a private company. And second, the requirement that an individual meet a monetary threshold ensures that if an investment does go bust, the individual is in a financial position to sustain the hit rather than potentially bankrupting them.

The author feels that a hybrid system of professional certifications and wealth can harmonize the accredited investor definition while at the same time promoting and aiding in capital formation. First, the author takes the position that if the Commission decides to simply “add[] categories of natural persons who qualify as accredited investors,” then the Commission should increase the required net worth and annual income for individuals. As articulated above, this increase should comport with the rate of inflation and increase the requirements to a level proportionally with that of which it was originally set.

Second, the author proposes that the Commission include various professional certifications that would qualify an individual as an accredited investor with the caveat that a professional certification, standing alone, will not suffice to satisfy the definition. The author proposes that if an individual wishes to obtain accreditation status via a professional certification, then that individual must also meet a specified monetary requirement, albeit a significantly lower threshold than one who seeks to gain accreditation solely on the basis of wealth. The reason for including some sort of financial requirement in conjunction with a professional certification is because many individuals obtain these certifications but incur significant amounts of debt in doing so and thus making a financial loss even more significant and catastrophic.

Requiring that an individual obtain a recognized financial certification (as approved by the SEC) as well reaching a certain monetary benchmark, adds another layer of protection to potential investors while at the same time allowing more individuals to qualify as an accredited investor and thus aiding in further capital formation.

⁶ 15 U.S.C. § 77b(a)(15)(ii).

Furthermore, the motivation for enacting the accredited investor definition in Regulation D—to clarify the private offering exemptions and the risk of liability for noncompliance—is mitigated due to the enactment of Rule 508. Rule 508 creates a safe harbor, stating that a failure to comply with the rules promulgated under Regulation D will not result in the issuer being stripped of their exemption as long as the failure to comply did not directly implicate a term, condition, or requirement which was directly intended to protect that particular individual or entity and so long as that failure to comply was insignificant to the offering as a whole and was made in good faith. With the enactment of Rule 508, issuers are able to rely on the safe harbor and are afforded the opportunity to avoid their loss of exemption due to the inadvertent issuance of a private stock to a nonaccredited investor. As such, the enactment of Rule 508 minimizes the need for an objective wealth-based accredited investor standard, because it removes the risk associated with making subjective determinations of accreditation. Although the safe harbor is more-so reversed for scenarios in which an issuer sells stocks to thirty-six nonaccredited investors as opposed to thirty-five,⁷ the protections of the rule should be extended to this context due to the ambiguity of a solely based wealth determination.

Permitting professional certifications to serve as the basis of accreditation status provides further clarity for issuers as these certifications are easily and readily available and often made public on various online registers. Although the need to obviate concerns about minor mistakes in the offering process is reduced under Rule 508, issuers would take comfort in having a clear and objective standard for determining potential investor status’.

- i. Are Professional Certifications and Designations or Other Credentials an Appropriate Standard for Determining Whether a Natural Person is an Accredited Investor?*

The author takes the position that the professional certifications and other credentials that the Commission proposes are an appropriate standard for determining accreditation, however, with the caveat that there is some modicum of financial requirement in tandem with it. The author believes that professional certifications such as the “Licensed General Securities Representative (Series 7),” the “Licensed Investment Adviser Representative (Series 65), and “Licensed Private Securities Offerings Representative (Series 82) are exactly the types of certifications that indicate financial sophistication which in turn would satisfy the accredited investor definition.

The author believes that there should be a nexus between the professional certification and the securities and financial markets. Although there are many ways to determine sophistication, certifications that directly pertain to the financial markets ensures that those individuals investing in an exempted offering are properly informed and can make an educated decision pertaining to the risks and rewards of a potential investment.

Requiring individuals to have professional certifications directly correlated to their field of expertise is no foreign concept—lawyers must pass the bar in order to practice law and accountants must pass the CPA exam in order to audit public companies. This should be the exact same standard for those who wish to participate in a highly sophisticated exempted securities market. With certifications such as the Series 7, Series 65, and Series 82 we can ensure that potential

⁷ 17 CFR 230.505.

investors in exempted securities have direct and pertinent knowledge as it relates to the purchase of securities.

Furthermore, these examinations are specifically developed and administered by FINRA which can further guarantee that anyone possessing these certifications are properly educated in the field of securities and thus are not vulnerable targets to unscrupulous and deceptive issuers. The author also believes that it is demeaning to holders of these certifications to say that they are permitted to give their expert opinion on investment strategies to other individuals yet at the same time are not certified themselves to actually partake in the purchase of exempted securities because they are not “sophisticated.”

ii. Should the Individuals be Required to Maintain These Certifications or Designations in Good Standing in Order to Qualify as Accredited Investors, as Proposed?

The author believes requiring individuals to maintain their certifications or designations in good standing achieves the objectives of the rule. Much like lawyers who must stay in good standing with the bar in order to practice law, individuals who gain accreditation status via professional certifications should also be required to be in good standing.

Due to the high volatility in the market and the constant developments in investment strategies, individuals who are accredited should be constantly informed about those changes. This protects investors from unscrupulous issuers who concoct new devices to mislead and defraud investors. Requiring certification holders to remain in good standing ensures that they are always informed about the changes in the market and how it operates and thus diluting the need for protections from the securities laws.

iii. Should Individuals be able to “Self-certify” Themselves as Accredited Investors?

The author believes that allowing individuals to “self-certify” that they have the requisite financial sophistication to be an accredited investor would be a mistake. Many individuals would be at risk of deception from issuers who persuasively convince investors to apply for accreditation status and thus obviate the protections of the securities laws. Furthermore, as a general principle of the securities laws, “sheep” can’t waive the protections. Simply allowing individuals to self-certify would undermine the entire definition and make any requirement of it meaningless.

Conclusion

The author reiterates his position that the current accredited investor definition, as currently implemented, does not afford potential investors the protections they need. The nexus between an individual’s wealth and financial sophistication is nearly negligible and thus does not “encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process

unnecessary.” The author feels that if a sole monetary requirement need be kept, then the threshold should at least be increased as to comport with the rate of inflation.

Furthermore, the author’s stronger position is that the Commission include an educational component to the accredited investor definition by allowing certain professional certifications in conjunction with a lowered monetary threshold to serve as the basis for accreditation status. By requiring individuals to have a professional certification which directly relates to the securities and financial markets, it ensures that investors have the ability to assess a potential investment opportunity—meaning that one has the ability to analyze the risks and rewards of the potential investment, the financial capacity to diversify their portfolio as to mitigate or avoid risk of unsustainable loss, or the means to obtain pertinent information about the issuer and the potential investment opportunity. By requiring an individual who wishes to gain accreditation status by virtue of a professional certification to also reach a lowered monetary threshold, we provide another layer of protection in case an investment goes bust while at the same time increasing the number of individuals who can participate in Regulation D offerings and thus aid in capital formation.

The author would like to thank the Securities and Exchange Commission for the opportunity to articulate his thoughts and beliefs on a very pertinent and important topic.

Sincerely,

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Hofstra Law School Class of 2021