March 15, 2016

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-25-19, Amending the "Accredited Investor" Definition

Dear Mrs. Countryman,

The undersigned is co-authored by two upper-level students at the Hofstra University Maurice A. Deane School of Law. The Co-authors,[1] Nicholas Bruno and Tyler Yagman (collectively, "the Co-authors") have researched the topics related to the proposal to change the "accredited investor" definition. Co-author Nicholas Bruno is a second-year law student with experience as a judicial intern for the Honorable U.S. Magistrate Judge A. Kathleen Tomlinson of the Eastern District of New York. He also has experience as a judicial intern for the Honorable Robert J. Miller of New York Supreme Court, Second Department. Additionally, Nicholas wrote his Note for the Journal of International Business & Law, which concerns the current and expected regulation of cryptocurrency. Nicholas has been elected the Editor in Chief of the Journal of International Business & Law for 2020-2021. Co-author Tyler Yagman is a second-year law student. Tyler has experience in capital markets as a trader. He has traded mortgage backed securities, high yield municipal debt and corporate debt, as well as high grade municipal and corporate debt. Tyler has been an active contributor to the blockchain space since 2011 in various capacities that range from consulting to development. He has also worked on the retail side of finance (wealth management) and has first-hand experience working with accredited investors and their specific needs.

The Co-authors are impressed by, and fully support, the Security Exchange Commission (the "SEC") and its current definition of, and regulations for, accredited investors. As evidence of its fortitude and efficacy, the SEC has maintained and enforced the Regulation D securities regulations for nearly four decades. The Co-authors fully support the SEC and the work it's done to promote suitability standards across the industry. The Co-authors also respect and support the SEC's decision to reevaluate the "accredited investor" definition. We believe that this can only further the great work that the SEC has accomplished.

The Co-authors hope that the SEC will consider the following two suggestions: (1) the SEC should modernize the threshold requirements that determines whether an individual or entity is an accredited investor; (2) the SEC should clarify ambiguities caused by 17 C.F.R. § 203.501(a)(3) and 17 C.F.R. § 230.501(a)(8). These suggestions stem from the following questions that the SEC

[1] Both Nicholas Bruno and Tyler Yagman reside at 402 Graduate Residence Hall, 400 Hofstra University, Hempstead, New York, 11549.

has posed to the public within the proposal; (1) "Additional Requests for Comment on the Accredited Investor Definition"[2] and (2) "Proposed Note to Rule 501(a)(8)."[3]

I. MODERNIZING THE THRESHOLD REQUIREMENTS THAT DETERMINE WHETHER AN INDIVIDUAL OR ENTITY IS AN ACCREDITED INVESTOR

The term "Regulation D security" ("Reg. D" or "Reg. D security" or "Reg. D securities") "relates to transactions exempted from the registration requirements of Section 5 of the Securities Act of 1933."[4] Reg. D securities are commonly offered through hedge funds, venture capital vehicles, and more esoteric financial instruments. Reg. D offerings are commonly composed of intricate investment strategies that utilize complex financial instruments that involve a heightened level of investment risk. Due to their complexity, investors need a higher degree of financial sophistication in order to understand the investment strategy and comprehend the risks involved with such investments.

Reg. D offerings are not for everyone as a result of their volatility, complexity, capital lock-up, and risk. The Security Exchange Commission defines a set of "qualifiers" for individuals and entities to curtail the possibility of investors allocating their capital to Reg. D offerings who are not appropriately suited to do so. If an investor meets any of these qualifiers, the investor is considered an "accredited investor" and is permitted to contribute capital to a Reg. D offering.

"The accredited investor definition attempts to identify 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."[5] It is vital that the SEC consider adopting new and more dynamic definitions of an accredited investor. The Co-authors propose the following three solutions to modernize the accredited investor thresholds: (1) adjust the net worth threshold for inflation and cost of living; (2) include an evaluation of net worth based on liquidity per asset class; (3) add a prong to the "gross income" definition to include an assessment of annual net investable capital. We believe these shifts better reflect the intent of forming the accredited investor definition as opposed to leaving the definitions unchanged.

A. The SEC Should Increase The Net Worth Threshold

The SEC establishes capital thresholds for individuals to qualify as accredited investors. An individual is an "accredited investor" if that individual has a net worth of at least $1,000,000 or has an income of at least $200,000, which increases to $300,000 if combined with a spouse, for each year in the prior two years with the expectation to make the same amount of income the following year.[6] The current net worth threshold no longer achieves the original intent of the SEC. The $1,000,000 threshold has remained unadjusted for nearly 40 years. While the SEC chose an

[2] *See* Amending the Accredited Investor" Definition [*hereinafter* Proposal], Release No. 33-10734; 34-87784, File No. S7-25-19, at 73-87 (2019).
[3] *See id.* at 59-60.
[4] 17 C.F.R. § 230.500(a).
[5] Staff of the Securities Exchange Commission, Report On The Review Of The Definition Of "Accredited Investor" [hereinafter Staff Report] 5 (2015).
[6] *See* 17 C.F.R. §§ 230.501(a)(5), (6).

appropriate and effective threshold at the time of promulgation, and has fairly and effectively enforced the threshold, the Co-authors propose that the SEC modify and elevate net worth thresholds, at a minimum, to reflect that they have been adjusted for inflation coupled with the rise in costs of living. The current accredited investor threshold is no longer an effective measure with which the SEC may designate investors as exempt who do not require the protections afforded by the Securities Act's registration process.

Inflation rates are monitored by comparing an indexed basket of consumer goods and services, called the Consumer Price Index (the "CPI" or "CPI"), from one time period to another. The United States Bureau of Labor Statistics calculates an average change in the costs of the goods in the CPI to track inflation rates over time. When the accredited investor definitions were adopted in 1982, the annual CPI for that year was 96.5.[7] The annual CPI for 2020 is 257.971.[8] CPI numbers from 1982 to 2020 results in a 167.33% increase.[9] $1,000,000 in 1982 provided more cushion and financial security that $1,000,000 today would. Therefore, the SEC should revisit the net worth threshold of the "accredited investor" definition because it no longer aligns with the original intent of the definition.[10]

B. Net Worth Minimums Do Not Allude To Financial Security

While lifting the net worth requirement nominally is a logical step forward, the Co-authors believe that it is paramount to determine suitability by assessing the liquidity of the individual's net worth. Currently, an investor must only reach the $1,000,000 threshold to be an accredited investor.[11] No assessment is conducted on the liquidity or break down by asset class of net worth.[12] If an investor qualifies as an accredited investor through net worth, but their assets are highly illiquid, does that individual not need the protection rights afforded by the SEC under its security registration regulations?

To illustrate the need to evaluate net worth for liquidity we offer the following example. Karl qualifies as an accredited investor via net worth and may freely invest in Reg. D offerings pursuant to the accredited investor definition.[13] No further assessment of Karl's net worth is required.[14] In this instance, a significant amount of Karl's net worth is allocated to illiquid assets, such as art or esoteric bonds. Karl decides to invest cash in a Reg. D offering and currently qualifies as an accredited investor. The investment takes significant losses. Karl wants to retrieve the remaining funds he invested into the Reg. D investment but is contractually unable due to capital

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[7] Databases, Tables & Calculators by Subject: Consumer Price Index For All Urban Consumers, U.S. Bureau of Labor Statistic, https://www.bls.gov/, (follow "All Urban Consumers: Top Picks" hyperlink; then select box titled "U.S. city average, All items" and select "Retrieve data" button; then select the date range "1982-2020" and select "include graphs" and "include annual averages" and select "Go.").
[8] *See id.*
[9] *See id.*
[10] *See id.*
[11] *See* 17 C.F.R. § 230.501(a)(5).
[12] *See id.*
[13] *See id.*
[14] *See* 17 C.F.R. § 230.501(a).

lock up clauses common with Reg. D offerings. Karl is now desperate for cash. While Karl may have reached the net worth mark, he is largely illiquid.

Like everyone, Karl has financial obligations. Karl must now consider selling his other assets to meet his financial obligations. However, esoteric bonds, and other illiquid asset classes, are subject to their own specific market nuances on top of global financial market variables. For example, a small pool of buyers might force Karl to sell his esoteric bonds at a large discount out of desperation. While a listed equity may take a millisecond to liquidate and a few days for the cash proceeds to become available, illiquid assets have potentially prolonged and unreliable time variables. These nuances add up and may significantly affect Karl's financial security.

The Co-authors propose that the SEC add a prong to the net worth definition of an accredited investor that accounts for the liquidity of an individual's net worth before they are considered accredited investors. If an investor's net worth is highly illiquid, or a significant percentage of the investor's assets are allocated to illiquid asset classes, the investor should not be considered an accredited investor due to their lack of true personal financial security.

C. Evaluation Of Net Worth Based On Liquidity Per Asset Class

An individual must gross $200,000 annually for the current and prior years as well as the next year in anticipation to be considered an accredited investor.[15] This amount increases to $300,000 if with a spouse.[16] Requiring only a gross income threshold to qualify as an accredited investor does not accurately illustrate the intention behind the definition of "accredited investor." Use of the gross income threshold to define accredited investors alone ignores the costs of living and other realistic life expenses, such as student loan payments, healthcare costs, and housing expenditures. A better bellwether with which the SEC may define accredited investors is by implementing the following dual pronged test: (1) gross income requirements (as they stand now); (2) a minimum threshold for a percentage of annual investable income.

To illustrate the use of the dual pronged test, we offer the following example. The Sanchez Household (the "Household") qualifies as an accredited investor by gross income.[17] However, the Household can only allocate a small percentage of their income to fund investment. The Household would still be able to invest in less risk averse Reg. D offerings. Currently, there are no guidelines that recommend that households with lower levels of investable income consider investing in common/traditional asset classes. The dual pronged test would alleviate this concern. Under the dual pronged test, the Household would instead likely invest in more traditional assets, such as a wealth management plan. The Co-authors recognize this is not a perfect fix to the problem. The Co-authors propose that the new dual pronged test should accompany an exception to the percentage of investable assets threshold. This will be an exception to the second prong as long as the investor had an established and funded wealth management plan.

II. POSSIBLE AMBIGUITY BETWEEN 501(A)(3) & 501(A)(8)

[15] *See* 17 C.F.R. § 230.501(a)(6).
[16] *See id.*
[17] *See id.*

The Co-authors propose the omission or, in the alternative, the amendment of 17 C.F.R. § 230.501(a)(8) ("501(a)(8)"). On one hand, 17 C.F.R. § 230.501(a)(3) ("501(a)(3)") prevents the application of the "accredited investor" definition to, among other things, limited liability companies ("LLCs") if formed "for the specific purpose of acquiring the securities offered."[18] On the other hand, 17 C.F.R. § 230.501(a)(8) ("501(a)(8)") applies the definition of "accredited investor" to "[a]ny entity in which all of the equity owners are accredited investors."[19] 501(a)(3) and 501(a)(8) dictate different applications of the "accredited investor" definition. But when read together, multiple accredited investors, in their individual capacities, may come together and form an LLC "for the specific purpose of acquiring the securities offered."[20] This creates an ambiguity in the definition of "accredited investor" within the Securities Act of 1933 (the "'33 Act"). The ambiguity creates the opportunity for non-accredited investors to pass money through the accredited investor LLC, acting as a funnel, to a Reg. D offeror. In order to mitigate this concern, the SEC consider the omission or amendment of 501(a)(8) that will prevent potential harm to non-accredited investors while simultaneously reasserting the original purpose of the regulation.

In order to illustrate the possible harm the ambiguity may pose, the Co-authors proffer the following hypothetical. A group of at least two individuals, each whose net worth exceeds $1,000,000, form a limited liability company ("LLC"), which makes the newly formed entity (*arguendo*, Wolfe Investors, LLC) an accredited investor.[21] Since 501(a)(8) lacks the clause that limits the purpose behind the formation of the entity (*i.e.*, "[a]ny organization . . . not formed for the specific purpose of acquiring the securities offered[]"), the two individuals may form Wolfe Investors, LLC ("Wolfe") for the specific purpose of acquiring securities. Within the regulatory gap created by 501(a)(3) and 501(a)(8), Wolfe may purchase unregistered Regulation D securities.

The regulatory gap does not only provide an ambiguity through which Wolfe-like entities may avoid registration requirements. It also provides a means by which Wolfe-like entities may take advantage of less financially sophisticated, non-accredited investors. Although they may operate within the regulatory gap created by 501(a)(3) and 501(a)(8), Wolfe and its members are still accredited investors. In theory, Wolfe and its members are more likely to have the ability to sustain a larger loss and may better fend for themselves as compared to non-accredited investors.[22] Through utilization of the regulatory gap created by 501(a)(3) and 501(a)(8), non-accredited investors may utilize Wolf-like entities as a vehicle through which it is possible to invest in unregistered Reg. D offerings.

In continuation of the hypothetical, a group of ten people, none of whom meet the requirements to be considered an accredited investor,[23] join together to pool their assets and establish an investment club (*arguendo*, "Sheepe Investment Club, LLC"). The members of

[18] 17 C.F.R. § 230.501(a)(3).
[19] 17 C.F.R. § 230.501(a)(8).
[20] 17 C.F.R. § 230.501(a)(3).
[21] *See* 17 C.F.R. §§ 230.501(a)(5), (8).
[22] *See* Staff Report, *supra* note 4, at 5.
[23] *See* 17 C.F.R. § 230.501(a).

Sheepe Investment Club, LLC ("Sheepe") have heard in the news that investments in hedge funds[24] have become increasingly lucrative. Sheepe's members wish to partake, but are disgruntled with the prohibition[25] on the sale of securities by hedge funds to those who are not considered "qualified purchasers."[26] By utilizing the regulatory gap created by 501(a)(3) and 501(a)(8), Wolfe may take Sheepe's pooled money and, acting as a qualified purchaser,[27] invest Sheepe's money with a hedge fund that offers an unregistered Reg. D security.

The ability for Wolfe to act as a funnel for Sheepe's money is entirely dependent on two factors; (1) Wolfe's compensation structure and (2) how Wolfe invests and handles Sheepe's money.[28] Given that Wolfe will to operate in the legally-gray area of the law, it is advantageous to minimize the number of applicable registration requirements. There are three registration hurdles Wolfe must clear: (1) Wolfe must be considered an accredited investor; (2) Wolfe must be considered a qualified purchaser; (3) Wolfe must not be considered a broker-dealer.

First, as noted above, Wolfe meets the definition of accredited investor because Wolfe Investors, LLC is an entity formed for the specific purpose of acquiring securities and all of its equity owners are accredited investors.[29] Second, also noted above, Wolfe, for the sake of the hypothetical, meets the definition of qualified purchaser, which allows Wolfe to invest in Reg. D securities through a hedge fund.[30] Third, Wolfe is not explicitly, at least under current law, a broker-dealer. The term "dealer" means "any person who engages in either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."[31] The courts and the SEC consider compensation structure an important factor to determine whether an individual or entity is a broker-dealer.[32] It is advantageous to avoid the classification of broker-dealer because the registration and regulation is burdensome.[33] Given the weight with which the SEC and the

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[24] The Co-authors' use of the "hedge fund" is purely for an illustrative purpose. The Co-authors acknowledge that other types of Reg. D offerors may be utilized in a way similar to which the hedge fund is utilized in the hypothetical.
[25] *See* Investment Company Act of 1940 [*hereinafter* ICA] § 80a-3(c)(7).
[26] *See* ICA § 80a-2(51)(A) ("[A]ny natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) . . . with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission.").
[27] *See* Securities Act of 1933 [*hereinafter* '33 Act] § 2(12) ("The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.").
[28] For the sake of the hypothetical, Wolfe will act with the intention of making money from the sheep by working within the legally-gray area that has been created by the ambiguity of 501(a)(3) and 501(a)(8). While Wolfe has the potential to act nefariously and exploit Sheepe, Wolfe will not do anything explicitly prohibited by law.
[29] *See* 17 C.F.R. § 230.501(a)(3), (8). Wolfe has already cleared this hurdle. *See*, *supra* p. 6, n.25.
[30] *See*, *supra* n.4-6.
[31] '33 Act § (2)(a)(12).
[32] *See* Securities Exchange Act [*hereinafter* '34 Act] § 15(h)(3)(A)(iii); *see also United States v. Braslau*, 665 F. App'x 573, 575 (9th Cir. 2016); *Fin. Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir. 2007); *see* David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 Cath. U. L. Rev. 899, 914 ("One bade of broker-dealer activity is derived from an interpretation of the connotations in the broker definition is the earning of commission. Commission compensation is a hallmark of a broker-customer relationship and demonstrates success in effecting transactions for the account of others.").
[33] *See* '34 Act § 15.

courts give compensation structure, Wolfe will likely avoid becoming a broker-dealer if it compensates its employees with a set salary or charges a flat fee in exchange for each account as opposed to utilizing a commission- or trade-based compensation structure.[34]

Now that Wolfe cleared the necessary hurdles and is not a broker-dealer, it may focus on how it handles and invests Sheepe's money. Once Wolfe is in possession of Sheepe's pooled money, it will approach the hedge fund and invest. While the hedge fund must comply with the regulations and limitations outlined in 17 C.F.R. §§ 230.502 ("502") and 506 ("506"), it is possible to do so because Wolfe is not a broker-dealer. The hedge fund must, among other things, take reasonable steps to verify the accredited investor and qualified purchaser statuses of Wolfe.[35] The transaction between Wolfe and the hedge fund will adhere to all necessary requirements for the purchase and sale of unregistered securities because it is bifurcated from the transaction between Wolfe and Sheepe. Therefore, upon the hedge fund's reasonable inquiry to determine whether Wolfe is "acquiring the securities for himself or for other persons,"[36] Wolfe may truthfully report that it will not resell the securities to other persons. Wolfe will then return the investment in its entirety of the profits to Sheepe. Wolfe has then effectively funneled Sheepe's money to and from a hedge fund. This hypothetical illustrates how Sheepe may act as an accredited investor by investing through Wolfe to purchase unregistered Regulation D securities. Sheepe may also act as a qualified purchaser by investing through Wolfe to gain access to a hedge fund, which is limited solely to accredited investors.[37] In essence, Sheepe is susceptible to accredited investor risk without accredited investor protection.

The impact of the situation exemplified by the hypothetical is strictly limited to a single transaction between one Wolfe-like firm, one Sheepe-like firm, and one hedge fund. The SEC has noted that "[d]ue to a lack of publicly available information about [LLCs], we are unable to estimate the number of [LLCs] that would qualify as accredited investors under the proposed rule."[38] While the SEC has a proposed the explicit addition of LLCs through an amendment to 501(a)(8),[39] it does not mitigate the ambiguity created by 501(a)(3). LLCs would still be able to operate as Wolfe Investors, LLC had operated. Additionally, this exposes Sheepe-like investors to more risk and increases the potential of being exploited by Wolfe-like investors.

"The accredited investor definition attempts to identify 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."[40] The intent to protect those who lack financial sophistication or lack the ability to fend for themselves is evident

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[34] *See Dervan v. Gordian Grp. LLC*, No. 16-CV-1694 (AJN), 2017 WL 819494 (S.D.N.Y. Feb. 28, 2017) (collecting cases) ("In ascertaining whether a particular individual falls within that definition, courts consider a variety of factors, including whether the individual . . . "received commissions as opposed to a salary". . . .").
[35] *See* 17 C.F.R. § 230.506(c)(2)(ii).
[36] *See* 17 C.F.R. § 230.502(d)(1).
[37] *See* ICA § 80a-2(51)(C).
[38] Proposal, *supra* note 1, at 53.
[39] *See id.* at 59-60 (2019).
[40] Staff Report, *supra* note 4, at 5.

in 501(a)(3) and 501(a)(8).[41] But while the minimum threshold value for assets for an organization along with the other threshold values identified in other sections of 501 are important, the clause that provides the most protection to the unsophisticated and those who cannot fend for themselves is, "[a]ny organization . . . not formed for the specific purpose of acquiring the securities offered."[42] This clause prevents Sheepe-like non-accredited investors from (1) circumventing the intent and protections of the '33 Act and (2) subjecting themselves to risks of loss they cannot sustain.

We propose either the omission of 501(a)(8) or the addition of "[a]ny organization . . . not formed for the specific purpose of acquiring the securities offered" to 501(a)(8).[43] In order to protect Sheepe-like investors, the "accredited investor" definition must be amended so as to prevent Wolfe-like accredited investors from becoming an unregistered investment vehicle through which Sheepe-like investors may be exposed to unsustainable risk of loss.

III. CONCLUSION

The Co-authors reiterate their hope that the SEC will view the suggestions outlined above as achievable and reasonable. Regulation D offerings have evolved in investment complexity year over year and will only continue to do so. Throughout the writing process, the Co-authors discussed, among other things, future technological innovations, newfound investment strategies and trends, the budding cryptocurrency space and their effects and risks imposed on accredited investors. The Co-authors place their complete trust in the SEC and its ability to protect vulnerable investors from risky investments and bad actors. The Co-authors hope that our comment will assist the SEC as it strives to refine the definition of "accredited investor." Thank you for opportunity to comment on this important issue. The Co-authors remain confident that the SEC will continue to protect investors.

Sincerely,

Tyler Yagman

Tyler Yagman

Nicholas Bruno

Nicholas Bruno

[41] *See* 17 C.F.R. § 230.501(a)(3) (setting a minimum threshold value for assets for an organization to fall under the definition of "accredited investor"); *see* 17 C.F.R. § 230.501(a)(8) (requiring all equity owners of an entity to be accredited investors).

[42] 17 C.F.R. § 230.501(a)(3).

[43] *Id.*