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ACCREDITED INVESTORS: A NEED FOR INCREASED PROTECTION IN PRIVATE OFFERINGS

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ABSTRACT—On June 19, 2019, the SEC released a report examining, in part, the adequacy of the accredited investor definition contained within Regulation D of the Securities Act of 1933 and soliciting public comment on potential changes to that definition. This Note argues that the current accredited investor definition, which determines who may invest in a private offering, does not adequately protect retail investors. Implemented in 1982 with fixed wealth requirements to qualify, the accredited investor definition has never been significantly revised, despite four decades of inflation that dramatically increased the percentage of households who meet the qualifications of an "accredited investor." Market developments have also increased the risk of investing in private offerings. These risks heighten the necessity for the accredited investor definition accurately to identify a group of investors who can evaluate the merits of a private offering and sustain any potential losses. To ensure that the accredited investor definition performs that job adequately, the SEC must revise the definition to meet the needs of the modern investing landscape. Specifically, this Note proposes that the accredited investor definition should require higher income and net worth thresholds that increase with the rate of inflation and that exclude retirement accounts from their calculation.

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INTRODUCTION

Venture capitalist Aileen Lee coined the term "unicorn" six years ago to describe a privately held startup valued at over $1 billion.[1] Once a rarity, there are now over 196 unicorn startups in the United States, with at least fifty-three reaching that status in 2018 alone.[2] Unlike a publicly traded company, which must comply with the registration requirements of the Securities Act of 1933 (the Securities Act), these startups and other privately held businesses rely upon exemptions from the Securities Act to raise capital

[1] *See* Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH, https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/ [https://perma.cc/67DV-5FCG].

[2] *See* Gené Teare, *The Crunchbase Unicorn Leaderboard Is Back, Now with a Record Herd of 452 Unicorns*, TECHCRUNCH (May 29, 2019 1:09PM), https://techcrunch.com/2019/05/29/the-crunchbase-unicorn-leaderboard-is-back-now-with-a-record-herd-of-452-unicorns/ [https://perma.cc/T8FW-E9C8]; *2018 Was the Best Year on Record for New U.S. Unicorns*, CBINSIGHTS (Feb. 26, 2019), https://www.cbinsights.com/research/us-unicorn-births-venture-capital-2018/ [https://perma.cc/22KG-4GGX]. Notable unicorns in recent years include Theranos, Lyft, Airbnb, SpaceX, WeWork, and Uber. *The Unicorn List*, FORTUNE, https://www.fortune.com/unicorns [https://perma.cc/3CKQ-CNEH].

by selling securities through private offerings.[3] With less than 0.02% of businesses in the United States publicly traded on an exchange, the amount raised through private offerings is huge—more than $3 trillion in 2017 compared to $1.5 trillion that was raised through registered offerings.[4]

Many companies choose to remain private because of the significant cost and regulatory burden of registering with the Securities and Exchange Commission (SEC).[5] While a lower regulatory burden benefits a company, it can create potential problems for investors. Issuers in a private offering are not subject to comprehensive disclosure requirements, so each investor must be aware of, ask for, and obtain all of the information necessary to make an informed investment decision.[6] Without the correct information, investors may be unable to tell whether they are investing in a legitimate business or the next Theranos.[7] Additionally, most securities sold through private offerings are restricted, requiring that they be held for a specified period, and do not have a well-established market, making their resale potentially difficult.[8] Because of these increased risks, the SEC has developed elaborate

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3 SEC OFFICE OF INV'R EDUC. AND ADVOC., *Investor Bulletin: Private Placements Under Regulation D*, INVESTOR.GOV (Sept. 24, 2014), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-private-placements-under [https://perma.cc/294K-ATJ9] [hereinafter *Investor Bulletin*] ("Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available."). In broad terms, a private offering is the selling of a company's securities that have not been registered with the SEC because of an exemption to the Securities Act and which is offered to only a limited set of sophisticated investors. *See id.* This Note will be limited to those private offerings conducted under Regulation D of the Act.

4 *See* SCOTT BAUGUESS ET AL., SEC, DIVISION OF ECONOMIC AND RISK ANALYSIS, CAPITAL RAISING IN THE US: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009–2017, 3–7 (Aug. 2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf [https://perma.cc/DTY5-NVNM].

5 *Id.* at 3 (recognizing that exemption from registration "particularly benefits smaller firms, for whom accessing public capital markets may generally be too costly").

6 *Investor Bulletin*, *supra* note 3.

7 Theranos was a privately held company that jumped to a $9 billion valuation in 2014 before it was discovered that the company had fraudulently misled investors about the capabilities of its blood testing technology. The firm dissolved in September 2018 with investors losing nearly $1 billion. John Carreyrou, *Blood-Testing Firm Theranos to Dissolve*, WALL ST. J. (Sept. 5, 2018), https://www.wsj.com/articles/blood-testing-firm-theranos-to-dissolve-1536115130 [https://perma.cc/ZFB9-UAAR]. The story of Theranos has turned into a cautionary tale, fully detailed in the book *Bad Blood* by Wall Street Journal investigative journalist John Carreyrou and a subsequent documentary on HBO. Margaret Lyons, *Theranos and Elizabeth Holmes: What to Read, Watch and Listen To*, N.Y. TIMES (Mar. 18, 2019), https://www.nytimes.com/2019/03/18/arts/television/theranos-elizabeth-holmes.html [https://perma.cc/V4N2-GRXH].

8 *Investor Bulletin*, *supra* note 3, at 1. Regulation D prescribes that securities sold under it "cannot be resold without registration under the Act or an exemption therefrom." 17 C.F.R. § 230.502(d) (2019). Rule 144 provides a frequently used exemption for the resale of restricted securities but requires that those securities be held for one year, or six months if the securities are issued by an Exchange Act

exemptive frameworks that govern private offerings and limit who may invest in them.[9]

The most frequently used exemption is found within Regulation D.[10] Regulation D allows a private company to raise an unlimited amount of money from an unlimited number of "accredited investors."[11] The definition of an accredited investor includes institutions such as banks and investment companies, as well as any natural person who has a net worth of over $1,000,000 or who has earned at least $200,000 per year for the past two years.[12] Intended to balance capital formation against investor protection,[13] the accredited investor definition uses wealth as a proxy to identify individuals whose financial knowledge, sophistication, and ability to withstand the risk of loss allow them to "fend for themselves" without needing the protections afforded by the Securities Act's registration process.[14]

When the accredited investor definition was adopted in 1982, the SEC made a policy choice to look only at an investor's wealth to provide issuers with a clear, objective standard[15] that could be easily administered to

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reporting issuer. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION CASES AND ANALYSIS 660 (Robert C. Clark et al. eds., 4th ed. 2015).

9 Section 5 of the Securities Act requires that all offers and sales of securities be registered with the SEC or fall within a designated exemption. 15 U.S.C. § 77e (2011). Section 4(a)(2) of the Securities Act exempts from registration any transaction not involving a public offering. *Id.* § 77d. This Note will be primarily concerned with Rule 506 of Regulation D, which provides a safe harbor for issuers looking to take advantage of the Section 4(a)(2) exemption. A safe harbor provides issuers with objective standards that, if met, create a presumption of compliance with the requirements of the exemption. *See Section 4(a)(2) and Regulation D Private Placements* (2019), Westlaw Practical Law Corporate & Securities Practice Note 8-382-6259.

10 Regulation D, 47 Fed. Reg. 11251 (proposed Mar. 16, 1982) (to be codified at 17 C.F.R. § 230). Of the $3 trillion raised through private offerings in 2017, $1.8 trillion was raised through Regulation D. BAUGUESS ET AL., *supra* note 4, at 7–8.

11 Regulation D's primary exemption is contained in Rule 506(b) which prohibits general solicitation of investments and allows an issuer to raise unlimited funds from an unlimited number of accredited investors and up to thirty-five other purchasers. 17 C.F.R. § 230.506(b) (2019). Rule 506(c) allows for general solicitation but is limited to only accredited investors. *Id.* § 230.506(c).

12 *Id.* § 230.501(a). For a full discussion of the accredited investor definition and its requirements, see *infra* Section I.D.

13 Revision of Certain Exemptions from Registration for Transactions Involving Ltd. Offers & Sales, 47 Fed. Reg. 11251, Release No. 33-6389 (Mar. 16, 1982) (to be codified at 17 C.F.R. §§ 230, 239) [hereinafter 1982 Release] (noting that Regulation D and the accredited investor definition were intended "to facilitate capital formation consistent with the protection of investors").

14 Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Securities Act Release No. 33-6683, 37 SEC Docket 588–89 (Jan. 16, 1987) [hereinafter 1987 Release].

15 *See* 1982 Release, *supra* note 13. Traditionally, objective criteria were viewed as absolutely critical because the sale of securities to an unqualified investor could lead to issuer liability not only for that investor but also all other purchasers. Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 301 (1994).

determine who was qualified to participate in a private placement.[16] That choice has done well for capital formation, with today's private markets booming;[17] however, over the last thirty-seven years, the protections offered to retail investors[18] by the accredited investor definition have not been maintained. The monetary thresholds that provide the sole means of determining who is able to "fend for themselves" have never been revised, despite the effects of almost four decades of inflation.[19] Without adjustment, the income and net worth requirements are effectively less than half of their original amounts, allowing "an ever-expanding group of individuals to qualify as accredited investors."[20] Accompanying this expansion are increased risks for today's accredited investors due to the approval of general solicitation in private offerings,[21] significant preemption of state securities laws, and an increase in the number of complex investment opportunities such as hedge funds.[22]

This Note argues that the SEC, in order to fulfill its statutory duty to protect investors, must revise the definition of an "accredited investor" to meet the demands of the modern investing landscape. Part I begins with a detailed look at the history of the accredited investor definition and examines the different exemptive frameworks that preceded it. Part II discusses how the investing landscape has changed since 1982 and analyzes several developments since then that have made investing in private offerings riskier. Part III argues that the current accredited investor definition fails to adequately protect investors and should be revised to increase its wealth

One error by the issuer could lead to disproportionate liability. *Id.* Rule 508, passed in 1989, helped to temper this concern by providing a safe harbor for unintentional, insignificant violations of Regulation D. However, concerns over compliance costs and ease of administration remain. *Id.*

16 A private placement is the offering of securities by an issuer that has not been registered with the SEC under Section 5 of the Securities Act. These offerings rely upon exemptions from the Securities Act. The term "unregistered offering" is often used interchangeably with private placement. *Unregistered Offerings: Overview* (2019) at 2, Westlaw Practical Law Corporate & Securities Practice Note 9-382-8837.

17 Almost $1.8 trillion was raised through Regulation D in 2017. This exceeds the amount raised through public equity and debt offerings combined. BAUGUESS ET AL., *supra* note 4, at 4.

18 In this Note, the term "retail investor" will refer to an individual, nonprofessional investor. This contrasts with larger institutional investors such as mutual funds, pension funds, insurance companies, or hedge funds.

19 *See infra* Section II.A.

20 CHOI & PRITCHARD, *supra* note 8, at 563.

21 General solicitation refers to an issuer's ability to market an offering using broad, non-targeted advertising through mass media sources such as television, radio, and the internet. *See Section 4(a)(2) and Regulation D Private Placements*, *supra* note 9, at 10–11. Previously, issuers were limited to soliciting only those with whom they had a "pre-existing, substantive relationship." William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143, 1152 (2013).

22 *See infra* Sections II.B–II.D.

thresholds, tie them to inflation moving forward, and remove retirement plans from the calculation of net worth. Part IV concludes with a call for action.

I. THE DEVELOPMENT OF REGULATION D AND THE ACCREDITED INVESTOR DEFINITION

Regulation D and the accredited investor definition trace back to the distinction between public and private offerings contained in the original Securities Act of 1933.[23] An offering occurs whenever a business sells its own securities to investors to raise the necessary capital to meet its operational objectives.[24] Although the conceptual difference between a public and a private offering may seem clear—namely the difference between offering securities on an open market or not—discerning what constitutes a private offering has proven a challenging question, and the SEC has long grappled with how to create workable rules that allow issuers to conduct private offerings with regulatory certainty.[25] The product of many prior efforts, the accredited investor definition can best be understood by first looking at its predecessors.

A. The Securities Act of 1933 and the Creation of the SEC

The Securities Act of 1933 was enacted in the midst of the Great Depression and sought to restore confidence in the nation's capital markets.[26] The Act regulated the offering and sale of securities, previously policed through a patchwork of state blue sky laws,[27] and was designed to prevent fraud through required disclosure.[28] The Act required that a security offering using interstate commerce be registered[29] and carry with it a robust series of disclosures[30] intended to provide investors with the ability to ascertain an

[23] 15 U.S.C. § 77d(2) (2011) (exempting transactions by an issuer not involving any public offering).

[24] CHOI & PRITCHARD, *supra* note 8, at 1.

[25] *See infra* Sections I.A–I.D.

[26] *What We Do*, SEC (June 10, 2013), https://www.sec.gov/Article/whatwedo.html#create [https://perma.cc/66XL-7QWY] [hereinafter *What We Do*].

[27] Blue sky is the colloquial name for specialized state statutes that were the almost exclusive form of regulating securities sales between 1911 and 1933. *See* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 (1991). Following the passage of the Securities Act, this web of state law was left intact to operate alongside federal regulation. CHOI & PRITCHARD, *supra* note 8, at 584. Congress eventually narrowed the scope of blue sky regulation in 1996 with the passage of the National Securities Markets Improvement Act. *See infra* Section II.C.

[28] 15 U.S.C. pmbl. (2012).

[29] *Id.* § 77e.

[30] *Id.* § 77aa.

"accurate judgment upon the value of the security."[31] To help facilitate registration and the disclosure of information necessary to make an informed investment decision, Congress established the Securities and Exchange Commission in 1934 and tasked it with enforcing the newly implemented statute.[32]

From its inception, the Securities Act contemplated exemptions for transactions "where there [was] no practical need for [the Act's] application or where the public benefits [were] too remote."[33] Section 4(a)(2) of the Act was one such exemption, creating a distinction between public and private offerings and exempting transactions not involving a public offering.[34] While creating a distinction, the Act provided little guidance on how to determine what distinguished a public offering from a private offering. The Office of General Counsel at the SEC soon recognized this issue and issued a guidance letter in 1935 enumerating factors that should be considered when making such a determination: the number of offerees and their relationship to each other and to the issuer; the number of units offered; the size of the offering; and the manner of the offering.[35] While courts did consider all four SEC factors in their review,[36] the number of offerees became the dominant factor, and offerings to fewer than twenty-five people were presumed to be private under the Securities Act.[37]

B. Judicial Attempts to Clarify the Private Offering Exemption

In 1953, the Supreme Court acknowledged the need to better define the scope of the private offering exemption and expressly rejected the then-standard method of relying on the number of offerees. In *SEC v. Ralston Purina Co.*, the Court examined the legislative history of the Securities Act and held that a determination of whether a public offering has occurred

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31 H.R. REP. No. 73-85, at 3 (1933). The registration statement required, *inter alia*, information on the character and capitalization of the business, the purpose of the funds raised through the securities offering, the financial statements of the company, essential facts relating to the identity and interests of the company's management and principal shareholders, and essential facts around the price of the security in relating to any earlier securities offerings by the company. *Id.* at 17–19.

32 *What We Do*, *supra* note 26.

33 H.R. REP. No. 73-85, at 5.

34 *Id.* at 16. Note that prior to the Securities Acts Amendments of 1964, Section 4(a)(2) was the second clause of Section 4(1).

35 Letter of Gen. Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 33-285, 1935 WL 27785 at *1–2 (Jan. 24, 1935).

36 *See, e.g.*, Campbell v. Degenther, 97 F. Supp. 975, 977 (W.D. Pa. 1951) (citing to the 1935 SEC letter and listing the four enumerated factors to be considered).

37 Lawrence A. Coles, Jr., *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395, 435–36 (1975).

should turn on whether the affected investors need the Act's protection.[38] An offering to sophisticated investors or those who were "able to fend for themselves" would not be a transaction "involving any public offering" because no practical need for registration existed.[39] The applicability of the Securities Act's protections thus depended on whether they were necessary in light of the investors involved. Notably, the Court also held that to qualify for a private offering exemption an issuer must demonstrate that it provided offerees with "access" to the same type of information as would have been available through registration.[40]

While *Ralston Purina* provided some clarity around the private offering exemption, commentators were critical of the sophistication and access standards because of their ambiguity and the practical difficulty in applying them consistently.[41] Lower courts began to interpret the sophistication requirement in a variety of ways, most focusing on an offeree's business or investment experience.[42] The access requirement was largely ignored until the early 1970s when the Fifth Circuit decided *Hill York Corp. v. American International Franchises, Inc.*[43] and *SEC v. Continental Tobacco Co.*[44]

In *Hill York*, the defendants relied on the fact that their offering was limited only to sophisticated professionals.[45] The court, while agreeing that sophistication was a factor of importance, placed a greater emphasis on access to the type of information that would be found in a registration statement.[46] It noted that the relationship between the issuer and offerees must give the offerees "special advantages" which made them different from the general public in their ability to obtain information from the issuer about its securities.[47] The following year, *Continental Tobacco* built upon this by

[38] 346 U.S. 119, 125 (1953).

[39] *Id.*

[40] *Id.* at 127.

[41] Julian M. Meer, *The Private Offering Exemption Under the Federal Securities Act—A Study in Administrative and Judicial Contraction*, 20 SW. L.J. 503, 505, 512–13 (1966) (stating that the viability of the exemption "may depend upon whether the [exemption] is ever challenged, and, if so, in what forum" which made "reliance on the private-offering exemption in any transaction a calculated business risk at best"); Fredrich H. Thomforde, Jr., *Exemptions from SEC Registration for Small Businesses*, 47 TENN. L. REV. 1, 16 (1979).

[42] *See, e.g.*, Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963) (affirming that the defendant's wide business experience and prior ownership of oil stocks "place[d] him in a class not needing the protection of the Act" in regards to the sale of a fractional oil lease); Repass v. Rees, 174 F. Supp. 898, 904 (D. Colo. 1959) (noting that the plaintiffs were "experienced businessmen and experienced investors" who "did not need the protection of the [A]ct").

[43] 448 F.2d 680 (5th Cir. 1971), *abrogated by* Pinter v. Dahl, 486 U.S. 622 (1988).

[44] 463 F.2d 137 (5th Cir. 1972).

[45] 448 F.2d at 690.

[46] *Id.* at 688–89 n.6.

[47] *Id.*

clarifying that "the mere disclosure of the same information that would be contained in a registration statement does not assure exemption."[48] Rather, it must be shown that each offeree had a prior privileged relationship with the issuer that gave the offeree access to the necessary information.[49] *Continental Tobacco* thus imposed a very high standard, causing some to believe that private offerings were effectively prohibited.[50]

C. Rule 146, Rule 242, and the Small Business Investment Incentive Act of 1980

The SEC responded to this uncertainty in 1974 by implementing Rule 146, which attempted to lay out more objective standards for issuers to follow when seeking an exemption from the registration requirement.[51] Under Rule 146, an issuer (1) could not offer or sell securities through any form of general solicitation or sell to more than thirty-five purchasers, (2) needed reasonable grounds to believe that the offeree had such knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment or reasonably believe that the offeree had the ability to bear the economic risk of the investment, and (3) must ensure that an offeree had access to or was furnished with the same kind of information that would be provided under the registration requirement of the Securities Act.[52] An issuer's compliance with the requirements of Rule 146 created a strong presumption that the issuer was entitled to a private-offering exemption. While Rule 146 sought to establish more objective criteria than the judicial opinions that preceded it, observers correctly predicted that it would "remain risky and relatively expensive for many small businesses to use the nonpublic offering route to raise needed capital" because of the disclosure requirements and the onus on an issuer to "make difficult, subjective decisions regarding an offeree's ability to fend for himself and bear the economic risk of the investment."[53]

By 1980, Congress and the SEC recognized that small businesses across the country were struggling due to difficulties raising the necessary capital

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48 *Cont'l Tobacco Co.*, 463 F.2d at 160.

49 *Id.* at 158–59. The court appears to have added this requirement to further clarify that disclosure alone was not sufficient to ensure an exemption. *Id.* at 160 ("[M]ere disclosure of the same information as is required in a registration statement is not the alpha and the omega . . . .").

50 Tom A. Alberg & Martin E. Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622, 628 (1974).

51 Notice of Adoption of Rule 146 Under the Sec. Act of 1933—Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 5487, 4 SEC Docket 154–55 (Apr. 23, 1974).

52 *Id.* at 158–60.

53 Alberg & Lybecker, *supra* note 50, at 643.

for growth.[54] Registration for a public offering and the preparation of the required disclosure documents took a small business close to six months and could cost around $660,000 in today's dollars.[55] With public offerings already cost-prohibitive for many businesses, the ambiguity of the Rule 146 exemption further exacerbated the challenge of capital formation, which made private offerings burdensome and risky for a small issuer.[56]

The SEC took action in 1980 with the adoption of Rule 242.[57] The rule created a new exemption from the registration requirement of the Securities Act and was intended to support small businesses in raising capital while protecting investors by replacing the sophistication and access requirements of previous exemptions with objective criteria for issuers to rely upon.[58] Rule 242 allowed certain issuers to sell up to $2 million of securities in a six-month period to an unlimited number of "accredited persons" and up to thirty-five other purchasers.[59] Accredited persons were defined as certain specified institutions, purchasers of $100,000 or more of securities, and executive officers or directors of the issuer.[60] If a sale involved only accredited persons, the issuer did not have to furnish them with any particular information; however, if a sale also included nonaccredited persons, the issuer was required to provide all purchasers with the information specified by the SEC.[61] By allowing individuals who purchased $100,000 or more of securities to qualify as accredited, the Rule was the first acknowledgement by the SEC that wealth could stand as a proxy for sophistication and the ability to fend for oneself.

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54 Susan E. Satkowski, Comment, *Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Businesses*, 23 WM. & MARY L. REV. 73, 73 (1981).

55 The cost at the time could be upwards of $200,000. *Id.* at 73–74. Adjusted for inflation, $200,000 in January 1980 would equate to $659, 532 in August 2019. *CPI Inflation Calculator*, BUREAU OF LABOR STATS., https://www.bls.gov/data/inflation_calculator.htm [https://perma.cc/G9G2-LCY8].

56 Rutheford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1144 (noting that the ambiguity of the access and sophistication requirements of Rule 146 created problems that were "significantly more difficult for the small issuer than for the larger company").

57 Exemption of Ltd. Offers & Sales by Qualified Issuers, 19 SEC Docket 295–96, Securities Act Release No. 6180 (Jan. 17, 1980) (to be codified at 17 C.F.R. § 230.242) [hereinafter Rule 242 Release].

58 *Id.* at 297.

59 *Id.* at 296. Rule 242 was limited to "Qualified Issuers," which included any domestic or Canadian corporate issuer that was not a limited partnership, an investment company, a company engaged in oil, gas, or mining operations, or a company otherwise non-exempt under Regulation A. *Id.* at 299.

60 *Id.* at 296. Specified institutions included banks, insurance companies, registered investment companies, small business investment companies registered with the Small Business Administration, and employee retirement plans, provided a plan fiduciary made the investment decision. *Id.* at 298.

61 Required information was contained in Part I of SEC Form S-18. *Id.* at 296. Form S-18 was an alternative method of registration that allowed for public offerings up to $5,000,000 and included more limited, but still quite extensive, disclosure. Satkowski, *supra* note 54, at 84 n.82.

The SEC viewed Rule 242 as experimental and intended to monitor it for an appropriate length of time before making an ultimate determination on whether it should be continued.[62] Congress soon forced the SEC's hand, however, with the passage of the Small Business Investment Incentive Act of 1980, which, like Rule 242, sought to reduce regulatory restraints on small business capital formation.[63] The Incentive Act, which was similar to Rule 242 in most regards, modified the Securities Act and exempted a sale of up to $5 million of securities from registration (up from Rule 242's exempted $2 million), provided that the securities were sold only to "accredited investors."[64] The Incentive Act limited accredited investors to specified institutions but also included a provision granting the SEC "rulemaking authority to expand th[e] definition to include additional types of purchasers as 'accredited investors' based on such factors as financial sophistication, net worth, knowledge, experience in financial matters, or assets under management."[65] Later that year, the SEC began an open comment period to examine the interrelationship between the recently enacted statute and the SEC's other exemptive rules.[66] After extensive review, the SEC determined that the then-existing registration and exemptive framework imposed a disproportionate restraint on small issuers (i.e., those trying to start small businesses).[67] The Commission's solution was Regulation D.[68]

D. Regulation D and the Adoption of the Accredited Investor Definition

Regulation D was adopted in 1982 as a safe harbor for the exemption within Section 4(a)(2) of the Securities Act.[69] Intended to promote capital

[62] Rule 242 Release, *supra* note 57, at 296.

[63] Small Business Investment Incentive Act of 1980, Pub. L. No. 96–477, 94 Stat. 2275 (1980); Satkowski, *supra* note 54, at 74–75.

[64] Consideration of the Impact of the Small Bus. Inv. Incentive Act on Certain Exemptions from Security Act Registration Provisions, Securities Act Release No. 6274, 21 SEC Docket 1013 (Dec. 23, 1980).

[65] *Id.* at 1018. The Incentive Act covered the same institutions as Rule 242 with the addition of "business development companies" that were defined in Section 2(a)(48) of the Investment Company Act of 1940 and intended to accommodate the need of "venture capital" activity. *Id.* at n.18.

[66] 1982 Release, *supra* note 13, at 11252.

[67] *Id.* at 11251.

[68] *Id.*

[69] *Id.* at 11256; Regulation D, 47 Fed. Reg. 11,251 (proposed Mar. 16, 1982) (to be codified at 17 C.F.R. § 230). Rule 506 of Regulation D provides issuers with objective standards that, if met, provide safe harbor exemptions under Section 4(a)(2) for private placements. *See, e.g.*, *Section 4(a)(2) and Regulation D Private Placements*, *supra* note 9, at 2. Regulation D is a nonexclusive safe harbor, meaning issuers can attempt to satisfy § 4(a)(2) directly by complying with SEC guidance and court opinions that have been delivered over the years. SEC, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 16 (Dec. 18, 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-

formation, particularly for small businesses, Regulation D established bright-line rules that provided issuers with certainty when conducting a private offering.[70] In adopting Regulation D, the SEC rescinded Rules 146 and 242[71] and replaced them with a series of six rules that set out three clear exemptions from the registration requirements of the Securities Act.[72] These exemptions were originally set out in Rules 504 to 506, with Rules 501 to 503 composed of generally applicable definitions, terms, and conditions. The SEC revised Regulation D in 2016 to eliminate Rule 505, leaving Rules 504 and 506 as its primary exemptions.[73]

Rule 504 allows for the sale of up to $5 million of securities to an unlimited number of investors with no prescribed disclosure requirements.[74] The rule is limited to noninvestment companies and was created for small offerings by small issuers with the intent that it be governed by existing state blue sky requirements.[75] Meanwhile, Rule 506 applies to all issuers, exempts them from state requirements, and allows them to raise an unlimited amount of money from an unlimited number of "accredited investors" and up to thirty-five other purchasers.[76] The rule initially prohibited general

18-2015.pdf [https://perma.cc/SXL7-FUX4] [hereinafter 2015 Report]. Few issuers choose this route as it is unpredictable and adds additional risk to the transaction. *Id.* at 47 n.175.

70 2015 Report, *supra* note 69, at 18. The SEC's stated purpose in designing Regulation D was "to simplify existing rules and regulations, particularly for small businesses, and achieve uniformity between state and federal exemptions in order to facilitate capital formation consistent with the protection of investors." *Id.* at 16.

71 Regulation D also rescinded Rule 240, which was adopted in 1975 to provide a safe harbor for closely held corporations owned by one hundred or fewer persons and allowed for an offering of $100,000 or less in any twelve-month period. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, 3 SECURITIES REGULATION 354–55 (5th ed. 2015). The rule prohibited general solicitation but did not contain an information or access to information requirement. *Id.* For further discussion on Rule 240, see generally Robert A. Kessler, *Private Placement Rules 146 and 240—Safe Harbor?*, 44 FORDHAM L. REV. 37 (1975) (discussing the background of Rule 240 and arguing that the rule is inadequate as a safe harbor for small businesses).

72 Regulation D, 47 Fed. Reg. at 11251–52.

73 *Exemptions to Facilitate Intrastate and Regional Securities Offerings*, 81 Fed. Reg. 83494, Release No. 33-10238 (Nov. 21, 2016) (to be codified at 17 C.F.R. §§ 200, 230, 239-40, 249, 270, 275). In this revision, the offering amount of Rule 504 was increased from $1 million to $5 million, rendering Rule 505 largely irrelevant. *Id.* Rule 505 previously allowed all issuers, except investment companies, to raise up to $5 million from an unlimited number of accredited investors and up to 35 other purchasers. CHOI & PRITCHARD, *supra* note 8, at 560–62.

74 17 C.F.R. § 230.504 (2019).

75 Regulation D, 47 Fed. Reg. at 11252.

76 17 C.F.R. § 230.506 (2019). Each purchaser who is not an accredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." § 230.506(b)(2)(ii). Rule 506 replaced Rule 146 and carried forward its concept of a purchaser representative whose knowledge and experience can substitute for that of the non-accredited purchaser. § 230.501(h). A purchaser representative, as defined under Rule 501, can be anyone with the knowledge or experience to evaluate the risks and merits of the investment except for an affiliate, director, officer or other employee of the issuer, or a beneficial owner of 10% or more of

solicitation but was amended in 2012 to add Rule 506(c) which permits general solicitation, provided that the offering is limited only to accredited investors.[77] Over time, Rule 506 has become the dominant exemption, accounting for 97% of total offerings under Regulation D and 99.9% of reported capital raised since 2009.[78]

Although Rule 506 is the most used exemption, the true centerpiece of Regulation D is its accredited investor definition. According to Rule 501(a), other than a limited exception for up to thirty-five nonaccredited purchasers, an individual must be deemed an accredited investor to participate in a Rule 506 offering.[79] This definition includes eight classifications under which an individual or entity can qualify as accredited.[80] In regard to natural persons, Rule 501(a) defines an accredited investor as an individual whose net worth, or joint net worth with a spouse, exceeds $1 million at the time of the purchase,[81] or whose income exceeds $200,000 (or $300,000 joint income with spouse) in each of the last two years with a reasonable expectation of that income continuing throughout the year of purchase.[82]

Regulation D thus fully embraced the concept, first introduced in Rule 242, of using wealth as a proxy for a natural person's ability to fend for themselves.[83] This change created a bright-line test that was objective, allowing investors to know if they qualified and issuers to verify easily those qualifications.[84] Since its introduction, the accredited investor definition

any class of the equity securities. *Id*. Exceptions to those disqualifiers are made if the purchaser representative is a relative of the purchaser, a trust or estate in which the purchaser representative is trustee or executor, or a corporation owned by the purchaser and purchaser representative. *Id*.

77 Congress, through a provision in the Jumpstart Our Business Startups Act, mandated that the SEC incorporate general solicitation under Regulation D; Rule 506(c) is the result of that mandate. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 § 201(a)(1), 126 Stat. 306, 314 (2012). Rule 506(b) continues to prohibit general solicitation along with purchases by up to thirty-five non-accredited investors.

78 BAUGUESS ET AL., *supra* note 4, at 13.

79 Rule 506(b) allows for the sale of securities to up to thirty-five nonaccredited purchasers; however, a sale to these purchasers requires that the issuer confirm the knowledge and experience of the investor or their purchaser representative and also imposes onerous disclosure requirements on the issuer. § 230.502(b). Because of these heightened requirements, only 7%–8% of Rule 506(b) offerings actually include nonaccredited purchasers. *See* BAUGUESS ET AL., *supra* note 4, at 35.

80 § 230.501(a)(1)–(8). In regard to entities, the definition provides classifications for banks, investment companies, employee benefit plans, savings or loan associations, private business development companies, corporations, trusts, and partnerships. *Id.*

81 § 230.501(a)(5).

82 § 230.501(a)(6).

83 Rule 242 allowed a purchaser of $100,000 or more of securities to qualify as an accredited person because it was believed that those individuals would have the bargaining power to acquire any information necessary to make an informed investment decision. Rule 242 Release, *supra* note 57, at 298–99.

84 1982 Release, *supra* note 13.

itself has not undergone significant revision. The only noteworthy change occurred in 2012 with the passage of the Dodd–Frank Act,[85] which mandated that the value of an investor's primary residence be excluded from the calculation of net worth.[86] Financial thresholds otherwise remain at the levels set in 1982, allowing an individual to qualify as accredited as long as they have a net worth of $1 million (excluding their primary residence) or have earned $200,000 for the past two years.[87]

II. THE PROGRESSIVE WEAKENING OF THE ACCREDITED INVESTOR DEFINITION

The Dodd–Frank Act mandated that, beginning in 2014 and at least once every four years thereafter, the SEC review the accredited investor definition as it applies to natural persons to determine whether the requirements of the definition "should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy."[88] While stated in slightly different terms than the SEC's mission statement, Dodd–Frank's required review attempts to balance the SEC's longstanding and sometimes opposing goals of facilitating capital formation and protecting investors.[89]

In August 2018, SEC Chairman Jay Clayton indicated that the Commission was working on a report that would, in part, review the accredited investor definition and examine whether the current rules that limit who can invest in private offerings should be expanded.[90] Released on

85 Dodd–Frank Wall St. Reform & Consumer Prot. Act, Pub. L. No. 111-203, § 413(b)(2)(A), 124 Stat. 1376, 1577–78 (2010). Dodd–Frank was passed in response to the Financial Crisis of 2008 and provided a broad overhaul of the financial regulatory system. For a discussion of Dodd–Frank's financial reforms and the motivations behind them, see John L. Ropiequet et. al., *The Dodd–Frank Act Changes the Consumer Finance Landscape*, 64 CONSUMER FIN. L.Q. REP. 284, 285 (2010).

86 Net Worth Standard for Accredited Inv'rs, 76 Fed. Reg. 81794, Release No. IA-3341 (Dec. 29, 2011) (to be codified at 17 C.F.R. §§ 230, 239, 270, 275) [hereinafter 2011 Release] (implementing Dodd–Frank § 413(a) that directed the SEC to immediately remove the value of an investor's primary residence from the calculation of individual and joint net worth).

87 § 230.501(a)(5)–(6).

88 Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(b)(2)(A), 124 Stat. 1376, 1577–78 (2010).

89 These goals trace back to the Securities Act of 1933 and are evidenced by the SEC's stated mission "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." *What We Do*, *supra* note 26. While the goals generally align, a conflict can occur if adequate investor protection requires barriers that impede on capital formation.

90 Jay Clayton, *Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival*, SEC (Aug. 29, 2018), https://www.sec.gov/news/speech/speech-clayton-082918 [https://perma.cc/AMT7-BV99]; Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals*, WALL ST. J. (Aug. 30, 2018), https://www.wsj.com/articles/sec-chairman-wants-to-let-more-main-street-investors-in-on-private-deals-1535648208 [https://perma.cc/M2BH-EH5C].

June 19, 2019, the SEC's report titled "Concept Release on Harmonization of Securities Offering Exemptions" builds upon a 2015 review by the SEC and solicits public comment on a number of alternative criteria to qualify as an accredited investor, including education, business, or investing experience, use of a professional, or even the administration of an accredited investor examination.[91] A recent bill passed by the U.S. House of Representatives echoes these proposals, allowing individuals who have education or job experience that demonstrates professional knowledge of a subject related to a particular investment to qualify after verification by the Financial Industry Regulatory Authority.[92] While many of these alternative criteria seem promising and should be explored further, they are likely to supplement rather than replace the current framework.[93] Monetary thresholds, despite being both over and underinclusive, have the key advantages of simplicity and ease of administration which allow issuers to conduct offerings with certainty, lowering the cost of capital and promoting its formation.[94] As a result, even if other alternatives are adopted, monetary thresholds likely will remain a central component of the accredited investor definition and must be maintained to adequately protect investors.[95]

This effort to expand the pool of accredited investors continues a trend since the adoption of Regulation D of focusing primarily on capital

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[91] SEC, CONCEPT RELEASE ON HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS 56–57 (2019), https://www.sec.gov/rules/concept/2019/33-10649.pdf [https://perma.cc/P6JW-XSCS] [hereinafter CONCEPT RELEASE]; 2015 Report, *supra* note 69, at 57–67.

[92] JOBS and Investor Confidence Act, S. 488, 115th Cong. § 401(a)(2)(E) (2018).

[93] *See* SEC, 37 GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION 17 (2019), https://www.sec.gov/info/smallbus/gbfor37.pdf [https://perma.cc/6YP6-ERNT] (recommending the maintenance of the existing monetary thresholds while expanding the categories of qualification for accredited investors status) [hereinafter "2018 Forum Report"]; Letter from SEC Advisory Committee on Small and Emerging Companies to Mary Jo White, Chair 3 (Mar. 9, 2015), https://www.sec.gov/info/smallbus/acsec/acsec-accredited-investor-definition-recommendation-030415.pdf [https://perma.cc/F6T2-CHRH] (offering recommendations regarding the accredited investor definition and recommending that current monetary thresholds be tied to inflation and new criteria that measure an investor's sophistication be adopted).

[94] The monetary thresholds may be overinclusive in that they qualify as accredited some individuals who are wealthy but not sufficiently sophisticated and may be underinclusive in that they exclude some individuals who may be sophisticated enough to invest in private placements but lack the necessary wealth. This point, inherent in any bright-line test, is also an issue with several of the alternative criteria proposed by the SEC. *See* 2015 Report, *supra* note 69, at 58–59 (acknowledging the challenges in deciding what educational degrees or professional certifications would be sufficient for an individual to qualify as accredited).

[95] *See supra* note 93 (citing recommendations to the SEC to preserve the monetary thresholds while adding additional criteria); *see also* STEVEN T. MNUCHIN & CRAIG S. PHILLIPS, U.S. DEP'T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 44 (2017), https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf [https://perma.cc/STG8-6K7M] (recommending expansion of the existing accredited investor definition to include additional ways of becoming accredited).

formation rather than investor protection. In the nearly four decades since the passage of Regulation D, there has been an almost uninterrupted liberalization of the accredited investor definition.[96] While thresholds for income and net worth have remained static, inflation has increased tenfold the number of households who qualify for accredited status.[97] This increase has been accompanied by the adoption of general solicitation in certain private offerings, significant preemption of state securities laws by federal law, and significant growth in the hedge fund industry, which presents accredited investors with increasingly complex investment opportunities.[98] With new risks and a pool of accredited investors that make up a far greater percentage of the population than what was originally contemplated, there is a real concern that the current accredited investor definition may not be sufficient to ensure that retail investors are adequately protected from risks of unregistered offerings.

A. Unchanged Income and Net Worth Thresholds

The most apparent and problematic aspect of the current accredited investor definition is that it has not been significantly revised since it was first implemented in 1982, even as the economic landscape within which it operates has shifted. Over the course of the last thirty-seven years, inflation has significantly degraded the financial thresholds that are the almost exclusive means of determining if a natural person qualifies as accredited.[99] When the definition was first introduced, only 1.5 million households, or 1.8% of households nationwide, qualified.[100] Today that number has grown to over 16 million, or 13% of households.[101] Assuming that the definition's financial thresholds had kept pace with inflation, an accredited investor in 2019 would need to earn annually over $500,000 or have a net worth of over $2.7 million to qualify, rather than the $200,000 of annual income or $1 million in net worth the law requires.[102] With no inflationary adjustments, many people qualifying today stand in a very different financial position to

96 The lone example of a more restrictive definition is Dodd–Frank's removal of an investor's primary residence from the net worth calculation. *See* 2011 Release, *supra* note 86.

97 Jean Eaglesham & Coulter Jones, *Opportunities to Invest in Private Companies Grow*, WALL ST. J. (Sept. 23, 2018, 1:00 PM), https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023 [https://perma.cc/6UQQ-DYMH].

98 *See infra* Sections II.B–II.D.

99 17 C.F.R. § 230.501(a)(4) provides a limited exception for a director, executive officer, or general partner of the issuer to qualify without needing to satisfy the financial thresholds.

100 2015 Report, *supra* note 69, at 48.

101 CONCEPT RELEASE, *supra* note 91, at 36.

102 Eaglesham, *supra* note 97. A dollar in March 1982 would have the same buying power as $2.71 in August 2019. *CPI Inflation Calculator*, U.S. DEP'T LABOR, BUREAU LABOR STAT., https://www.bls.gov/data/inflation_calculator.htm [https://perma.cc/QF4M-L35W].

those envisioned by the SEC when Regulation D was first adopted. These investors may not have the sophistication necessary to participate in a private offering nor the ability to sustain a loss of investment.

The SEC and Congress have both recognized the potential issues in an expanding accredited investor pool and have proposed revisions that would remedy those issues. In 2007, the SEC recommended changes to the accredited investor definition that would have indexed its financial thresholds to inflation every five years moving forward.[103] The SEC acknowledged that by failing to adjust the definition, it had "effectively lowered the thresholds in terms of real purchasing power."[104] A public comment period was then held on the proposal where, similar to prior attempts to adjust the monetary thresholds, opinions were split along interest group lines, with the business lobby opposing any change that could potentially impede capital formation[105] and consumer watchdogs pushing for more stringent requirements to protect investors.[106] The business lobby ultimately prevailed, and the proposed changes were delayed as a new Director of Corporate Finance took over. They were never revisited.[107]

Congress also sought to tackle this issue. In 2010, a provision within an early draft of Dodd–Frank would have required the SEC to set financial thresholds at an amount higher than their current level and adjust them for

[103] Revisions of Limited Offering Exemptions in Regulation D, 91 SEC Docket 699–700, Securities Act Release No. 33-8828 (Aug. 3, 2007).

[104] *Id.* at 699.

[105] *See, e.g.*, Nat'l Venture Cap. Ass'n, Comment Letter on Release Nos. 33-8828; IC-27922 (File No. S7-18-07) Revisions of Limited Offering Exemptions in Regulation D 3 (Oct. 9, 2007), https://www.sec.gov/comments/s7-18-07/s71807-68.pdf [https://perma.cc/RU2D-UN88] (recommending that the SEC retain the current net worth and income standards); Lee W. Mercer, Nat'l Ass'n of Small Bus. Inv., Cos., Comment Letter on File Number S7-18-07 2 (Oct. 8, 2007), https://www.sec.gov/comments/s7-18-07/s71807-28.pdf [https://perma.cc/UJ2C-LQTN] ("[There is] no need to increase the amounts specified for net worth and income criteria applicable to accredited investors under Regulation D as currently written . . . .").

[106] *See, e.g.*, Karen Tyler, North Am. Secs. Adm'rs Ass'n, Inc., Comment Letter on Revisions of Limited Offering Exemptions in Regulation D, (Oct. 26, 2007), https://www.sec.gov/comments/s7-18-07/s71807-57.pdf [https://perma.cc/8JBZ-H4N7] (approving of proposed inflation adjustments and recommending that the SEC go even further to account for the previous twenty-five years with no adjustment); Bryan J. Lantagne, Massachusetts Secs. Div., Comment Letter on Revisions of Limited Offering Exemptions in Regulation D 6–7 (Oct. 12, 2007), https://www.sec.gov/comments/s7-18-07/s71807-53.pdf [https://perma.cc/7QVW-AY5G] (advocating that the SEC significantly raise the financial thresholds and adjust them for inflation moving forward).

[107] During a 2008 speech at the Business Law Fall Meeting, John W. White, then-Director of the SEC's Division of Corporation Finance, noted in regards to the proposed changes to Regulation D that he "truly thought [he would] get this one done by the close of the year, but reality [had] set in;" thus it would be "one for the next director." John W. White, SEC, Division of Corporation Finance, Keynote Address at the ABA Section of Business Law Fall Meeting: Don't Throw Out the Baby with the Bathwater (Nov. 21, 2008), https://www.sec.gov/news/speech/2008/spch112108jww.htm [https://perma.cc/X7WS-FB2Y].

inflation every five years thereafter.[108] This proposal was similarly opposed by the business lobby and ultimately omitted from the final Dodd–Frank Act.[109] While Congress and the SEC have not taken action to this point, a tenfold increase in the number of qualifying households creates a very real concern that the accredited investor definition no longer identifies a group of investors with the wealth and presumed qualifications to be able to truly "fend for themselves without the protections afforded by registration."[110]

B. Rule 506(c) and the Approval of General Solicitation

Since the Securities Act was first adopted, private offering exemptions have almost entirely prohibited the use of general solicitation or advertising in an offering.[111] The SEC interprets general solicitation broadly, including the solicitation of anyone with whom an issuer does not have "a pre-existing, substantive relationship."[112] A relationship is considered substantive if it "would enable the issuer . . . to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise [is] of some substance and duration."[113] This "pre-existing, substantive relationship" standard created a high bar for issuers and greatly restricted the pool of potential investors to whom they could conceivably sell their securities.[114] Conversely, it also provided a limiting force on the number of private investment opportunities that an accredited investor could face.

This changed in 2012 with the passage of the Jumpstart Our Business Startups Act (the JOBS Act), which directed the SEC to remove its prohibition on general solicitation for certain private securities offerings,

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108 *See* Restoring American Financial Stability Act, S. 3217, 111th Cong. § 412 (2010) (directing the Commission to increase the financial thresholds for the accredited investor definition "by calculating an amount that is greater than the amount in effect on the date of enactment of this Act of $200,000 income for a natural person (or $300,000 for a couple) and $1,000,000 in assets, as the Commission determines is appropriate" and "adjust[ing] that threshold not less frequently than once every 5 years, to reflect the percentage increase in the cost of living").

109 Jennifer J. Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993, 1003 n.62 (2012).

110 Proposed Revision of Certain Exemptions from the Registration Provisions of the Sec. Act of 1933 for Transactions Involving Ltd. Offers & Sales, 23 SEC Docket 465, Securities Act Release No. 6339 (Aug. 7, 1981).

111 A limited exception existed under Rule 504 provided that the offering was registered in a state requiring the use of a substantive disclosure document or that the securities were sold under a state exemption permitting general solicitation and the sale was limited to accredited investors. 17 C.F.R. § 230.504.

112 Sjostrom, *supra* note 21, at 1152.

113 *Id.* (citing Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2811, at *2 (Dec. 4, 1985)).

114 *Id.* at 1152–53.

including those made under Rule 506.[115] The SEC responded with Rule 506(c), first released on July 10, 2013, which allows issuers under Rule 506 to conduct general solicitation provided that securities are sold exclusively to accredited investors.[116] Though it was designed with the intent of promoting job creation by providing small businesses with increased access to capital, the rule applies to businesses of all sizes—including pooled investment funds—and allows those businesses to market their securities through the Internet, television, and social media with little scrutiny by the SEC.[117]

While some applauded Rule 506(c) for removing barriers to growth for emerging companies,[118] criticism quickly mounted. Commentators decried the lack of economic analysis that went into the rule's formulation and the potential harm that could occur to investors through the mass marketing of often risky private investments that can be difficult to resell.[119] Dissent even came from inside the SEC, with then-Commissioner Luis Aguilar voting against the rule and noting that "general solicitation clearly has the potential to put investors at risk" as it allows "fraudsters to cast a wider net for victims."[120]

Critics like Luis Aguilar are particularly concerned about vulnerable investor groups such as the elderly, who may have the lifetime earnings necessary to qualify as an accredited investor, based on the standard's dated wealth requirements, but lack the sophistication necessary to make informed

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115 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 314 (codified at 15 U.S.C. § 77d note (2012)).

116 Eliminating the Prohibition Against Gen. Solicitation & Gen. Advert. in Rule 506 & Rule 144A Offerings, 78 Fed. Reg. 44771, Securities Act Release No. 33-9415 (July 24, 2013) (to be codified at 17 C.F.R. §§ 230, 239, 242).

117 Manning Gilbert Warren III, *The False Promise of Publicly Offered Private Placements*, 68 SMU L. REV. 899, 900–01 (2015).

118 *See, e.g.*, William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 4 (2004).

119 *See, e.g.*, Consumer Federation of America, Americans for Financial Reform & AFL-CIO, Comment Letter on the JOBS Act General Solicitation Rulemaking (Apr. 23, 2013), https://www.sec.gov/comments/s7-07-12/s70712-254.pdf [https://perma.cc/5H78-KS6Y] (criticizing the rule in its current state because it would "deny investors much needed protections as it throws open the door to mass marketing of these often risky and illiquid 'private' securities"); A. Heath Abshure, President, North Am. Secs. Adm'rs Ass'n Inc., Comment Letter on Release No. 33-9354 "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A" (Oct. 3, 2012), https://www.sec.gov/comments/s7-07-12/s70712-92.pdf [https://perma.cc/UCQ5-DNVW] (recognizing that there were competing interests behind the passage of the rule but expressing disappointment that it failed to "implement any protections for investors, even those that would be minimally burdensome to issuers").

120 Luis A. Aguilar, *Facilitating General Solicitation at the Expense of Investors*, SEC (July 10, 2013), https://www.sec.gov/news/public-statement/open-meeting-statement-laa-3#_edn9 [https://perma.cc/MHR5-UUC7].

investment decisions.[121] Besides having higher concentrations of wealth which may make them a target, the elderly may face increased risk of being defrauded due to poor physical health, mental impairment, or dependency on others.[122] As one study on elder exploitation put it, "[o]lder adults are more likely to have financial resources than their younger counterparts, and this, in combination with the higher prevalence of social isolation, cognitive impairment, and other factors, renders them uniquely susceptible to financial exploitation."[123] These individuals were previously protected if they had no preexisting relationships with issuers but may now be solicited for a wide range of complex private offerings by complete strangers who may not have their best interest in mind.[124]

The dangers of general solicitation manifested in the SEC's recent suit against the Woodbridge Group of Companies (Woodbridge) and its directors, brokers, and advisers, who relied upon Rule 506(c) to defraud thousands of investors. The organization, led by owner Robert H. Shapiro, raised more than $1.22 billion through unregistered securities offerings from over 8,400 investors nationwide.[125] Solicited through advertisements across multiple media platforms, investors were promised high returns from the interest that Woodbridge made lending to third parties.[126] Despite raising

[121] *Id. See also* Jason Zweig, *Want to Buy a Private Stock?*, WALL ST. J. (Sept. 7, 2012, 6:30 PM), https://www.wsj.com/articles/SB10000872396390443589304577637790108826970 [https://perma.cc/36GL-NQ32] (quoting a former Michigan state securities regulator who voiced concerns that the elderly would be targeted and noted that "many investors worth more than $1 million are afflicted with Alzheimer's or other forms of dementia—and are thus especially prone to having their money pried out of them by the promotions the new law makes possible").

[122] STEPHEN DEANE, SEC OFFICE OF THE INV'R ADVOCATE, ELDER FINANCIAL EXPLOITATION: WHY IT IS A CONCERN, WHAT REGULATORS ARE DOING ABOUT IT, AND LOOKING AHEAD 1 (2018), https://www.sec.gov/files/elder-financial-exploitation.pdf [https://perma.cc/M4JQ-JTKH].

[123] Janey C. Peterson et al., *Financial Exploitation of Older Adults: A Population-Based Prevalence Study*, 29 J. GEN. INTERNAL MED. 1615, 1615 (2014).

[124] The North American Securities Administrators Association (NASAA) included private offerings on its annual Top Investor Threats List in 2013, stating that "the advertising of private offerings . . . will lead to greater abuse by unscrupulous promoters." *NASAA Expands Annual Top Investor Threat List*, NASAA (Oct. 15, 2013), http://www.nasaa.org/27012/nasaa-expands-annual-top-investor-threats-list/ [https://perma.cc/TQK2-PN3H]. Recently, the Consumer Financial Protection Bureau also reported that suspected cases of financial exploitation of the elderly had increased 19% in 2017 and were nearly three times the level reported in 2014. *See* Yuka Hayashi, *Elder Fraud on the Rise*, WALL ST. J. (Feb. 27, 2019), https://www.wsj.com/articles/elder-fraud-on-the-rise-11551309306 [https://perma.cc/74X7-EKCF].

[125] Amended Complaint for Injunctive and Other Relief at 2, SEC v. Shapiro, No. 17-cv-24624-COOKE/GOODMAN (S.D. Fla. May 4, 2018); *see also* Press Release, SEC, SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors (Dec. 21, 2017), https://www.sec.gov/news/press-release/2017-235 [https://perma.cc/T6BS-556Q].

[126] Amended Complaint, *supra* note 125, at 2, 14–15. In an effort to avoid registration of its securities, Woodbridge claimed that its offering was limited only to accredited investors. *Id.* at 18. Though making that claim, Woodbridge did nothing to evaluate whether the individuals it solicited qualified under the accredited investor definition. *Id.* at 23.

over $1 billion, Woodbridge turned out to be a Ponzi scheme that actually generated only $13.7 million in interest income and used new investments to pay expected returns to its existing investors.[127] When this scheme collapsed in 2017, Woodbridge filed for Chapter 11 bankruptcy, leaving investors with losses of over $961 million.[128] Of the 8,400 defrauded investors, at least 2,600 invested retirement savings, amounting to nearly $400 million.[129] Woodbridge recently reached a settlement, agreeing to pay $1 billion in penalties and disgorgement. However, it remains to be seen at what level investors will be able to recover.[130]

While Ponzi schemes have been around for years, Woodbridge demonstrates how general solicitation can now be used by "fraudsters to cast a wider net for victims" in those schemes.[131] Today's expanded pool of accredited investors may be presented with investment opportunities through social media or through a phone call from a complete stranger. These investors need to be sophisticated enough to evaluate the merits of those offerings and able to withstand any potential losses. Although use of Rule 506(c) has remained relatively limited so far,[132] general solicitation creates new risks that necessitate a strengthened accredited investor definition.

C. Preemption of State Securities Laws

The accredited investor definition has also come to play an increased role in protecting investors because of Congress's decision to allow state securities laws to be significantly preempted by federal law. When the Securities Act was first passed, it left intact the complex web of state blue sky regulations, permitting states to continue their own registration and exemption requirements for securities sold to their citizens.[133] While many of these state regulations came to mirror their federal counterparts over

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[127] *Id.* at 2.

[128] *Id.* at 2–3.

[129] *Id.* at 14.

[130] *See* Press Release, SEC, Court Orders $1 Billion Judgment Against Operators of Woodbridge Ponzi Scheme Targeting Retail Investors (Jan. 28, 2019), https://www.sec.gov/news/press-release/2019-3 [https://perma.cc/3YYL-BE5G]; Jay Weaver, *A $1.2 Billion Ponzi Case Settles, but Will Victims Ever See Their Money—or Justice?*, MIAMI HERALD (Feb. 2, 2019; 12:01 PM), https://www.miamiherald.com/news/local/article217040845.html [https://perma.cc/U3XV-UDYW] (noting that investor recovery could be limited to fifty to seventy percent or less of initial investments and may take years).

[131] *See* Aguilar, *supra* note 120.

[132] Since its inception only $255 billion, or 4% of total capital, raised under Regulation D has been conducted pursuant to Rule 506(c). BAUGUESS ET AL., *supra* note 4, at 2.

[133] Daniel J. Morrissey, *The Securities Act at Its Diamond Jubilee: Renewing the Case for a Robust Registration Requirement*, 11 U. PA. J. BUS. L. 749, 774 (2009).

time,[134] states continued to maintain an emphasis on the merits of an offering rather than the mere disclosure of its details.[135] These state laws served as "a second line of protection for investors, one that saw to it they would be treated fairly."[136]

This changed when Congress passed the National Securities Markets Improvements Act of 1996 (NSMIA).[137] The NSMIA was a deregulatory reform which preempted the state regulation of "covered securities," including private placements made pursuant to Rule 506.[138] The Act was designed to reduce the cost of capital and facilitate capital formation by eliminating redundant and unnecessary state securities regulations.[139] To achieve this goal, the NSMIA preempted state law for all private exemptions under Rule 506, regardless of whether they were national in scope or made within the borders of a single state.[140]

While states are still permitted to conduct ex-post fraud investigations and prosecution, they no longer function as "'local cops' on the beat" for Rule 506 offerings.[141] Local regulators note that prior to the NSMIA, states often used violations of their local registration provisions to stop fraud at an early stage.[142] Federal preemption eliminated this tool, meaning states must now prove fraud in order to stop it.[143] This requires significant time and effort, taxing already limited state resources, and exposing the public to harm for a greater period of time.[144] Indeed, after the passage of the NSMIA, regulators "observed a steady and significant rise in the number of offerings

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134 Annual Conference on Uniformity of Sec. Laws, 31 SEC Docket 1045–46, Securities Act Release No. 6561 (Dec. 6, 1984) (endorsing a Uniform Limited Offering Exemption promulgated by the NASAA that was intended to coordinate with Regulation D and be uniform among the states).

135 UNIF. SEC. ACT § 304 (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2005).

136 Morrissey, *supra* note 133, at 775.

137 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

138 *Id.* § 102(a) (codified at 15 U.S.C. § 77r(a)–(b)); Sjostrom, *supra* note 21, at 1152.

139 Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 156 (2010).

140 *Id.* at 154.

141 *Id.* at 154, 159 (quoting *Capital Markets Deregulation and Liberalization Act of 1995: Hearings on H.R. 2131 Before the Subcomm. on Telecomm. and Fin. of the H. Comm. on Commerce*, 104th Cong. (1995)).

142 *See* North American Secs. Adm'rs Ass'n, Comment Letter on the Definition of Qualified Purchaser; Release No. 33-8041 (Mar. 4, 2002), https://www.sec.gov/rules/proposed/s72301/borg1.htm [https://perma.cc/R7XL-SXWS].

143 *Id.*

144 *Id.*

made pursuant to Rule 506 that [were] later discovered to be fraudulent."[145] This reduction in state regulation, combined with the minimal oversight given to private placements by federal law, has created what one commentator calls "a regulatory black hole."[146] In this black hole, the accredited investor definition provides the primary method of shielding vulnerable investors from fraud or other investment schemes. The definition's standards must be strengthened to ensure that it is performing its job adequately.

D. A Changing Investment Landscape—The Proliferation of Hedge Funds

Accredited investors also face significantly more complex investment opportunities relative to when Regulation D was first adopted in 1982. This change is most apparent in the tremendous growth of the hedge fund industry.[147] Few hedge funds operated in the early 1980s, and those that did advertised through word of mouth and had high minimum requirements that limited investment to a close network of very rich individuals.[148] In 1990, there were roughly 600 active hedge funds containing $40 billion in assets.[149] By 2018, those numbers had increased dramatically to 9,175 funds containing $3.969 trillion in net assets.[150] These funds may invest in unusual assets that are difficult to accurately value, and investors often face opaque fee arrangements, limitations on their ability to redeem shares, and limited disclosure with which to make investment decisions.[151]

A majority of today's funds are lightly regulated and escape registration under the Securities Act by structuring their offerings as Rule 506 private placements that are limited only to accredited investors.[152] Hedge funds are

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[145] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Hearing Before the Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 86 (2009) (statement of Fred J. Joseph, President, NASAA).

[146] Johnson, *supra* note 139, at 155.

[147] A hedge fund pools money, generally from accredited investors, and invests that money with the hope of a positive return. Hedge funds have significant flexibility in the type of investments that they can make and often pursue more speculative strategies than other investment vehicles such as mutual funds. *See Investor Bulletin: Hedge Funds*, INVESTOR.GOV (Oct. 3, 2012), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-hedge-funds [https://perma.cc/KWL6-5LB6].

[148] Jan Fichtner, *The Rise of Hedge Funds: A Story of Inequality*, 2 MOMENTUM Q. 3, 6 (2013).

[149] *Id.*

[150] SEC DIV. OF INV. MGMT. ANALYTICS OFFICE, PRIVATE FUNDS STATISTICS: FIRST CALENDAR QUARTER 2018, at 4–5 (Nov. 13, 2018), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2018-q1.pdf [https://perma.cc/ZG25-KSV2].

[151] *Hedge Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/investment-products/hedge-funds [https://perma.cc/D3X9-7YC4].

[152] *Implications of the Growth of Hedge Funds*, STAFF REP. TO THE U.S. SEC. AND EXCHANGE COMMISSION 11 (2003), https://www.sec.gov/news/studies/hedgefunds0903.pdf [https://perma.cc/R3QF-8N3Q] ("Hedge funds . . . typically rely on one of two statutory exclusions from

currently the largest private fund issuer under Regulation D and have raised almost $3.1 trillion since 2009 with $382 billion raised in 2017 alone.[153] While hedge funds are also subject to the Investment Company Act of 1940 and its registration requirements, that Act also contains significant exemptions from registration for funds that are limited to "qualified purchasers"[154] or for smaller funds with 100 or fewer investors.[155] Known as 3(c)(1) funds for the exemption they use, these smaller funds are of particular concern to this discussion because the accredited investor definition serves as the primary gatekeeper to supposedly identify those investors capable of evaluating the risks and merits of the investment. This is not an easy task given the lack of required disclosure and wide range of complex investment methods hedge funds employ, which often include short selling, substantial leverage, and exotic arbitrage strategies.[156] Unlike investors in the stock of a public company, who can rely upon mandated disclosure and securities prices that will generally be an accurate reflection of that information, investors in private funds must know what information to request from the fund and be sophisticated enough to evaluate that information themselves to make an informed decision.[157]

Following a decade of significant growth[158] and the publicized failure of several high-profile hedge funds,[159] the SEC revisited its exemption

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the definition of investment company, which enables them to avoid the regulatory provisions of that Act."); Fichtner, *supra* note 148, at 8 (stating that hedge funds typically try to be exempt under the Securities Act in order "to prevent having to reveal proprietary trading strategies and other information").

153 *See* BAUGUESS ET AL., *supra* note 4, at 22.

154 15 U.S.C. § 80a-3(c)(7) (2018). The standard for qualified purchaser is more demanding than that for accredited investor and requires that an individual own at least $5 million in investments. 15 U.S.C. § 80a-2(a)(51)(A)(i) .

155 § 80a-3(c)(7)(B)(ii)(I).

156 *See* Fichtner, *supra* note 148, at 9.

157 This assumes the efficient capital markets hypothesis (ECMH), which was developed by economists in the 1960s. CHOI & PRITCHARD, *supra* note 8, at 30–31. Under the semi-strong version of the ECMH, which is generally accepted in securities regulation, the stock price of a company's actively traded stock will reflect all relevant publicly available information. *Id.* at 31. Thus, retail investors purchasing that stock can be confident that its price is an accurate reflection of all public information without needing to do any research themselves. *Id.* This is not the case in private placements where information is not widely dispersed and securities are lightly traded.

158 SEC Staff Report, *supra* note 152, at 1 n.4 (noting that hedge fund assets grew from $50 billion in 1993 to $592 billion in 2003, a 1084% increase).

159 The failure of Long-Term Capital Management (LTCM) in 1998 and Amaranth Advisors in 2006 both received extensive media coverage. LTCM, which was leveraged 25 to 1 with derivative positions in excess of $1.5 trillion, suffered staggering losses from miscalculations on risky debt and government bonds. *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 984. Banks, including the Federal Reserve Bank of New York, were forced to invest $3.5 billion to avoid a global financial crisis. *Bailout of Long-Term Capital Sets Markets Reeling and Hands Wringing*, WALL ST. J. (Sept. 25, 1998, 6:00 PM), https://www.wsj.com/articles/SB906738963166811000. Amaranth Advisors, the largest hedge fund at

framework in the early 2000s to see if revisions were necessary to adequately protect investors. This review culminated in a proposed rule in 2006 that would have added a new category of accredited investor called an "accredited natural person."[160] As proposed, the new category would apply to 3(c)(1) funds and limit the offering and sale of their securities to investors who met the existing net worth or income requirements under Rule 501(a) and also owned at least $2.5 million in investments.[161] The new rule was "designed to help ensure that only investors that are capable of evaluating the merits and risks of investments in certain 3(c)(1) Pools may invest in such pools."[162] The SEC admitted that the existing definition of "accredited investor" might insufficiently protect investors in part because inflation and increases in wealth and income have brought many potential investors above the thresholds necessary to qualify them as accredited.[163] Despite its concerns, the SEC ultimately never adopted the new rule with no explicit rationale provided.

Following the SEC's failure to implement the accredited natural person standard, inflation continues to expand the pool of accredited investors, magnifying concerns that the standard provides insufficient protection to ensure that less sophisticated retail investors are protected from the unique risks of investing in a hedge fund. A prime example of these risks is the complete loss recently suffered by the hedge fund OptionSellers. Headed by founder James Cordier, OptionSellers was a Florida-based hedge fund that pursued high returns through an aggressive investment strategy in commodities.[164] Predicting a warmer than expected 2018 winter, Cordier bet against natural gas and made the imprudent decision to sell naked call options, an unhedged position carrying unlimited risk.[165] These options

the time, collapsed after a wrong-sided bet on natural gas that lost the fund $5 billion in just over a week. Ann Davis et al., *What Went Wrong at Amaranth*, WALL ST. J. (Sept. 20, 2006), https://www.wsj.com/articles/SB115871715733268470 [https://perma.cc/T8DU-8DVL].

160 Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, Release No. 33-8766 (Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275).

161 *Id.* at 405.

162 *Id.* at 413.

163 *Id.*

164 *See* Naureen S Malik et al., *Founder of Stricken Hedge Fund Promoted Naked Option Selling*, BLOOMBERG (Nov. 20, 2018, 8:33 PM), https://www.bloomberg.com/news/articles/2018-11-21/founder-of-stricken-hedge-fund-promoted-selling-of-naked-options [https://perma.cc/637B-345P].

165 *Id.*; Susan Taylor Martin, *Tampa Bay Lightning Owner Jeff Vinik Among Clients Who Lost Money in Collapse of Tampa-Based Investment Fund*, TAMPA BAY TIMES (Nov. 23, 2018), https://www.tampabay.com/business/in-youtube-video-tampa-hedge-fund-manager-apologies-for-losing-millons-of-his-clients-money-20181123/ [https://perma.cc/9LJX-JR77]. A "naked call" is one in which the seller of the call option does not actually own the underlying commodity. Evan Niu, *What is a Naked Call?*, THE MOTLEY FOOL (May 11, 2016, 11:00 AM), https://www.fool.com/investing/

would profit if the price of the commodity fell, but on November 14, in what Cordier would refer to as a "rogue wave," the price of natural gas shot up nearly twenty percent for its biggest intraday gain since 2010.[166] FCStone Inc., the brokerage that cleared trades for OptionSellers, was forced to liquidate the fund's accounts to cover its position.[167] When these accounts did not prove sufficient to cover the naked options, FCStone borrowed on margin against its own clients' accounts and notified OptionSellers' investors that they would owe an additional $35.3 million beyond what they had originally invested, for total losses exceeding $150 million.[168] While litigation seems likely,[169] the fund does not appear to have been fraudulent and investors are unlikely to recover any of their losses. The demise of OptionSellers exemplifies the risks inherent in certain hedge funds and, more importantly, demonstrates the need for a strong accredited investor definition that can be reasonably expected to identify a group of investors capable of evaluating those risks.

III. PROPOSED REVISIONS TO THE CURRENT DEFINITION

When the SEC adopted Regulation D in 1982, the accredited investor definition avoided the pitfalls of earlier exemptions by providing issuers with an objective, bright-line test that could be reliably administered.[170] The definition looks solely at wealth as proxy for sophistication and the ability to fend for oneself.[171] Because wealth is currently the sole determinant of who is able to invest in a private offering, it is essential that the monetary thresholds be maintained to reliably identify those investors who truly do not need the protections offered by registration. In 1983, only 1.8% of all households met that demanding standard.[172] Today, as a result of inflation and inaction, that number has increased to thirteen percent, encompassing some sixteen million households.[173]

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options/2016/05/11/what-is-a-naked-call.aspx [https://perma.cc/Y9S6-WLFN]. It carries unlimited risk as the commodity's price could rise to any level before the option is exercised. *Id.*

166 Malik, *supra* note 164.

167 Simon Casey et al., *Broker Seeks $35 Million From Customers of Wiped-Out Fund Manager*, BLOOMBERG (Nov. 29, 2018, 5:06 PM), https://www.bloomberg.com/news/articles/2018-11-29/broker-seeks-millions-from-customers-of-wiped-out-fund-manager [https://perma.cc/A5GF-2VFL].

168 *Id.*

169 Attorney John Chapman has already brought a suit for gross negligence against broker FCStone and notes that "Option Sellers may face legal action as well." *Attorney Sues After Tampa Hedge Fund Goes Under*, FOX 13 (Jan. 15, 2019, 11:14 PM), https://www.fox13news.com/news/local-news/attorney-sues-after-tampa-hedge-fund-goes-under [https://perma.cc/6VMB-4A5W].

170 See *supra* Part II for a discussion of predecessors to Regulation D.

171 17 C.F.R. § 230.501(a)(5)–(6).

172 2015 Report, *supra* note 69, at 48.

173 CONCEPT RELEASE, *supra* note 91, at 36.

A tenfold increase in the number of households qualifying as accredited might be justified if there were new developments that lowered the risk of investing in a private offering. However, that has not been the case.[174] Despite the expansion of the accredited investor pool, investors may now be solicited to participate in private offerings by complete strangers, receive less protection as a result of the preemption of state securities laws, and face increasingly complex investment opportunities from issuers such as hedge funds.[175] As such, revisions must be made to improve investor protection. To ensure that the accredited investor definition captures only those investors "whose financial sophistication and ability to sustain the risk of loss . . . render the protections of the Securities Act's registration process unnecessary,"[176] the definition's wealth thresholds should be increased and tied to inflation moving forward. Additionally, retirement accounts should be excluded from the calculation of net worth to more accurately identify investors capable of bearing the risks of investment.

A. Increase Income and Net Worth Thresholds

If the monetary thresholds of the accredited investor definition were adjusted for inflation since March 1982, an investor in 2019 would need to earn about $543,000 per year (or $814,500 with spouse) or have a net worth of about $2,714,900 to qualify.[177] Some commentators have called for a full and immediate increase to those levels along with periodic inflationary adjustments moving forward.[178] The SEC itself has actually had success with

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[174] One could argue that technology has improved overall access to market information allowing investors to become more sophisticated as a whole; however, this does not relate to access to the information on a specific company involved in a private offering. This issuer-specific information is what is necessary to make an informed investment decision. The argument also does not consider the investor's ability to bear the risk of loss, which is a crucial piece of the existing accredited investor definition.

[175] *See supra* Sections II.B–II.D.

[176] 1987 Release, *supra* note 14, at *2.

[177] Amounts were calculated using the Bureau of Labor Statistics' CPI Inflation Calculator. The time period examined was March 1982 to August 2019. *CPI Inflation Calculator*, BUREAU OF LABOR STAT., https://www.bls.gov/data/inflation_calculator.htm [https://perma.cc/HE6N-529J].

[178] *See, e.g.*, Managed Funds Association, Comment Letter on Managed Funds Association Regulatory Priorities 39 (May 18, 2017), https://www.sec.gov/comments/s7-07-16/s70716-1761663-152156.pdf [http://perma.cc/G3AS-9WAU] (recommending that the SEC amend the income and net worth thresholds to account for inflation and indexing those thresholds for inflation moving forward); North Am. Sec. Adm'rs Ass'n., Inc., Comment Letter on SEC's Report on the Review of the Definition of "Accredited Investor" 3 (May 25, 2016), https://www.sec.gov/comments/4-692/4692-34.pdf [https://perma.cc/K79T-3PV3] (same); Pub. Inv'rs Arbitration Bar Ass'n, Comment Letter on the SEC Staff's December 18, 2015 Report on the Definition of "Accredited Investor" 3 (May 17, 2016), https://www.sec.gov/comments/4-692/4692-33.pdf [htpps://perma.cc/R8G5-LSMS] (same); Cornell Law School, Securities Law Clinic, Comment Letter on Report on the Review of the Definition of "Accredited Investor" 4–5 (Apr. 30, 2016), https://www.sec.gov/comments/4-692/4692-28.pdf [https://perma.cc/75V9-PXTA] (same).

that approach in its revision of the "qualified client" definition under the Investment Advisers Act of 1940.[179] A qualified client under that Act is currently defined as a natural person who has at least $1 million in assets under management or who has a net worth that exceeds $2.1 million.[180] Those thresholds were previously set in 1998 at $750,000 and $1.5 million and were increased by Section 418 of Dodd–Frank to account for inflation between 1998 and 2010.[181] Dodd–Frank also mandated that the thresholds be adjusted for inflation every five years after, with the first inflationary adjustment taking place in 2016.[182]

While it might be ideal to have the accredited investor definition fully account for inflation if the adjustments are made progressively, it is unlikely that a one-time increase to account for *thirty-seven years* of inflation would be feasible today. Issuers in 2017 raised $1.8 trillion through Regulation D, more than through all registered offerings.[183] Small business advocates are rightly concerned that such a dramatic change to such an important source of capital could be disruptive and have a materially adverse effect on the market.[184] Additionally, if the thresholds were made too restrictive, issuers could choose to forgo Regulation D's safe harbor and attempt to conduct private offerings directly through the exemption provided by Section 4(a)(2) of the Securities Act.[185] This route would increase complexity, since issuers would need to comply with the securities law of each state involved in the offering and would also create greater uncertainty overall.[186]

Fortunately, the SEC is not restricted to an all-or-nothing increase nor is it required to raise both monetary thresholds equally.[187] Given this

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179 17 C.F.R. § 275.205-3 (2012).

180 Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 Under the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-4421, 81 Fed. Reg. 39985, 39986 (June 14, 2016) [hereinafter 2016 Order].

181 Exemption to Allow Investment Advisers to Change Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. IA-1731, 67 SEC Docket 1235, 1243 (July 15, 1998); Dodd-Frank Wall Street Reform and Consumer Protection Act, § 418, 15 U.S.C. 80b-2 note (2010).

182 2016 Order, *supra* note 180, at 2–3.

183 BAUGUESS ET AL., *supra* note 4, at 7–8 (stating that Regulation D constituted $1.8 trillion of the total $3 trillion raised through all private placements).

184 *See* Angel Capital Association, Comment Letter on Accredited Investor Definition Comment and Recommendations 1, 3 (Feb. 28, 2014), https://www.sec.gov/comments/s7-06-13/s70613-490.pdf [https://perma.cc/84A3-EU4D] (recommending no change to the existing financial thresholds as an increase would cause the "startup ecosystem [to] face grave disruption from a dramatic shrinkage of [the] vital investor pool, especially in regions where venture capital is not prevalent.").

185 2015 Report, *supra* note 69, at 47.

186 *Id.* at 47 n.175.

187 Dodd–Frank gives the SEC the power to adjust the monetary thresholds "as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy."

flexibility, the SEC should make it a priority during its upcoming review to conduct a thorough economic analysis of the impact that raising the monetary thresholds would have on companies' abilities to raise capital and the protection provided to investors. Based on this analysis, the SEC could then determine increases to each threshold that would afford greater investor protection without unduly impeding capital formation.[188] Though an increase to the existing thresholds would be beneficial itself, the more important piece will be adjusting that amount for inflation moving forward. This change is less controversial[189] and should not prove burdensome to the SEC because it could be done every four years during the review already mandated by Dodd–Frank.[190] Together, an immediate increase in the wealth thresholds coupled with inflationary adjustments moving forward, would provide improved protection now and ensure that this investor protection would not be eroded in the future.

B. Exclude Retirement Plans from the Calculation of Net Worth

Along with the changes discussed above, the SEC should exclude retirement plans from the calculation of net worth for accredited investors. Today, 401(k) plans alone hold \$6.2 trillion in assets and have more than 97.6 million participants, with both figures increasing each year.[191] By mid-2018, individual retirement accounts (IRAs) held an additional \$9.3 trillion

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§ 413(b), 15 U.S.C. 77b note (2010). Market developments since the passage of Regulation D, such as the removal of an investor's primary residence from the calculation of net worth, may justify a larger increase to one threshold in comparison to the other. *See* 2011 Release, *supra* note 86.

[188] This general approach has been endorsed by several commentators. *See, e.g.*, Certified Fin. Planner Bd. of Standards, Inc., Comment Letter on Proposed Amendments to Regulation D, Form D and Rule 156 Under Securities Act 7 (Dec. 19, 2014), https://www.sec.gov/comments/s7-06-13/s70613-608.pdf [https://perma.cc/VB54-KQQG] (urging the SEC to conduct an economic analysis in order to "find a point at which investors receive meaningful protection and issuers are able to raise the capital they need cost-effectively"); Consumer Fed'n of Am. & Ams. for Fin. Reform, Comment Letter on Report on the Review of the Definition of "Accredited Investor" 3 (Apr. 27, 2016), https://www.sec.gov/comments/4-692/4692-26.pdf [https://perma.cc/Y5CG-UWE6].

[189] The SEC received over fifty comments on its 2015 Accredited Investor Staff Report with only two explicitly rejecting inflationary adjustments on an ongoing basis. *See* National Small Business Association, Comment Letter on the SEC Report on the Review of the Definition of Accredited Investor (Mar. 29, 2016), https://www.sec.gov/comments/4-692/4692-18.pdf [https://perma.cc/QB23-ATPE] ("Indexing the thresholds levels for the accredited investor definition may complicate compliance as the thresholds will change."); Small Business Investor Alliance, Comment Letter on the SEC Report on the Review of the Definition of Accredited Investor (Mar. 7, 2016), https://www.sec.gov/comments/4-692/4692-15.pdf [https://perma.cc/75ZZ-HFWQ] (arguing that adding new inflationary adjustments moving forward would reduce the pool of potential investors and hurt small business investment).

[190] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, § 413(b)(1)(B)(2), 15 U.S.C. § 77b note (2010).

[191] *401(k) Fast Facts*, AM. BENEFITS COUNCIL (Jan. 2019), https://www.americanbenefitscouncil.org/pub/e613e1b6-f57b-1368-c1fb-966598903769 [https://perma.cc/4GKU-MATF].

and made up nearly one-third of the U.S. retirement market.[192] While investing in a retirement account of this type is certainly a prudent financial decision, it is not a reliable indicator of the ability to fend for oneself when determining accredited investor status.[193]

Prior to Dodd–Frank, it was common for investors to qualify as accredited largely because of the value of their primary residence—an asset critical to that investor's well-being and one not closely tied to the individual's investment ability.[194] This changed in 2011 when the accredited investor definition was revised to exclude the value of an investor's primary residence from the calculation of net worth.[195] The SEC at that time noted that "[o]ne purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore less liquid) securities for an indefinite period and, if necessary, to afford a complete loss of such investment."[196] Those qualifying solely as the result of the home they lived in were clearly not a group who could afford complete loss of investment.

Many of the same concerns related to an investor's primary residence apply equally to that investor's retirement accounts. Investors who are retired or nearing retirement may qualify as accredited investors entirely on the basis of retirement accounts that have been built passively over the investor's lifetime.[197] The SEC's Investor Advisory Committee voiced concern that many of these investors could qualify based on a "nest egg that they rely on to provide regular income that will need to last them throughout their

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[192] *Frequently Asked Questions About Individual Retirement Accounts (IRAs)*, INV. CO. INST. (June 2019), https://www.ici.org/faqs/faq/Individual-Retirement-Accounts-(IRAs)-FAQs/ci.faqs_iras.print [https://perma.cc/9GDN-5QAR].

[193] This same logic applies to government or private sector defined benefit plans where wealth is passively built and no investment sophistication is needed. A defined benefit plan provides a fixed monthly payment upon retirement that is calculated through a plan formula, often looking at factors such as the employee's salary at retirement and length of service. *Types of Retirement Plans*, U.S. DEP'T LABOR, https://www.dol.gov/general/topic/retirement/typesofplans [https://perma.cc/8XAL-STQ9].

[194] Manning G. Warren III & Marc L. Steinberg, Comment Letter on SEC Release No. 33-9177 (Jan. 31, 2011), https://www.sec.gov/comments/s7-04-11/s70411-14.pdf [https://perma.cc/G2EA-XXCU].

[195] Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81793, 81793 (Dec. 29, 2011).

[196] *Id.* at 81794.

[197] *Recommendation of the Investor Advisory Committee: Accredited Investor Definition*, INV. ADVISORY COMM. 3 (Oct. 9, 2014), https://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf [https://perma.cc/3LUN-EEZC] [hereinafter Advisory Committee Report]. The Investor Advisory Committee is a product of Dodd–Frank and intended to advise the SEC "on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace." *Spotlight on Investor Advisory Committee*, SEC (Feb. 14, 2017), https://www.sec.gov/spotlight/investor-advisory-committee.shtml [https://perma.cc/U3YG-9JTT].

remaining years."[198] These individuals are unable to absorb significant losses and would suffer adverse consequences if this planned retirement income was reduced.[199]

This issue will continue to become more predominant as a growing number of people reach retirement age. By 2030, it is anticipated that 74 million, or one in five persons, in the United States will be age sixty-five or over.[200] That number is projected to grow to 88 million by 2050 and to more than 98 million by 2060.[201] These individuals frequently need the wealth built up in retirement accounts to sustain themselves and also face increased risks of being defrauded as a result of age-related factors.[202] As a result, they do not represent a population well-suited to investing in private placements. While the exclusion of retirement accounts will undoubtedly reduce the current pool of accredited investors,[203] this reduction may be offset by the adoption of alternative criteria[204] and will allow the net worth threshold to serve as a more accurate indicator of sophistication, helping to ensure that the accredited investor definition identifies only those who truly can fend for themselves.

CONCLUSION

Since its adoption in 1982, the accredited investor definition has done well for private capital formation but has not been adequately maintained to protect investors. Thirty-seven years of inflation, along with increased investor risk because of other market developments, has culminated in a definition that can no longer be relied upon to identify a group of investors suitable for private placements. In order to fulfill its dual goals of facilitating capital formation and protecting investors, the SEC should increase the accredited investor definition's income and net worth thresholds, tie those new amounts to inflation moving forward, and consider excluding retirement accounts entirely from the calculation of net worth. Through those changes, the definition can once again identify those capable of fending for themselves in a private offering.

198 Advisory Committee Report, *supra* note 197, at 3.

199 *Id.* at 4.

200 DEANE, *supra* note 122, at 2.

201 *Id.*

202 *See supra* notes 121–124 (discussing factors that increase investment risk for older individuals).

203 In 2015, the SEC estimated that 9.21 million households qualified as accredited investors through the net worth test and that this number would drop to 6.75 million if retirement accounts were excluded. 2015 Report, *supra* note 69, at 51.

204 See *id.* at 57–67 for a discussion of some alternative criteria that the SEC has considered.