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Modernizing The Accredited Investor Definition

I. INTRODUCTION

In the United States, all securities must be registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 or qualify for an exemption from registration requirements.[1] If an issuer desires to raise capital through the public capital market, a public offering, the issuer must register both the securities and the offer with the SEC.[2] However, the process of going public is both time consuming and expensive. Issuers are subject to federal securities laws for each capital raise, if an exemption is not perfected.[3] As a result, many issuers opt to raise capital through the private markets, utilizing a private offering, which are not subject to the onerous registration requirements of the Securities Act of 1933. For example, in 2019 more capital was raised through private securities offerings than the amount of capital raised through public securities offerings.[4] Specifically, in 2019, the amount of capital raised in exempt offerings was approximately $2.7 trillion, while the amount raised in public, registered offerings was approximately $1.2 trillion.[5]

Section 4(a)(2) of the Securities Act of 1933 provides that registration requirements do not apply to a "transaction by an issuer not involving any public offering."[6] This Section 4(a)(2) exemption still exists today, but the majority of capital raised through private offerings occurs through Regulation D.[7] In 2019, approximately $1.55 trillion of capital was raised through Regulation D exemptions, while approximately $1.17 trillion of capital was raised through other private offering exemptions, such as Regulation A, Regulation Crowdfunding, and other exempt offerings.[8]

Regulation D creates safe harbors that an issuer can utilize to perfect an exemption from registration.[9] Regulation D created three safe harbors: Rules 504, 506(b), and 506(c).[10] Of these three exemptions, 506(b) and 506(c) have accounted for over 99.9% of the securities sold through Regulation D.[11] As between Rule 506(b) and Rule 506(c), far more capital is raised under the 506(b) exemption.[12] In 2019, approximately $1.49 trillion of capital was raised under Rule 506(b), while $66 billion of capital was raised under Rule 506(c) of Regulation D.[13]

As the statistics bear out above, capital raised under the 506(c) exemption has accounted for a small portion of the capital raised in Regulation D offerings, around 4%, while the vast majority of capital raised through Regulation D has been raised through Rule 506(b) exemption.[14] In both the 506(b) and 506(c) safe harbors, issuers are permitted to sell to an unlimited amount of "accredited investors."[15] The amount of non-accredited investors allowed in Rule 506(b) offerings is limited to 35 investors, while non-accredited investors are not allowed to participate in offerings under the Rule 506(c) exemption.[16]

Additionally, the Jumpstart Our Business Startups Act (JOBS Act) of 2012 amended Rule 506(c) to allow issuers to engage in general solicitation.[17] Examples of general solicitation are provided in Rule 502(c), and include advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by general solicitation or advertising.[18] The definition of accredited investor is very important in light of this change to Rule 506(c) and the widespread use of the Rule 506(b) exemption, given that both private offering exemptions are either wholly or primarily limited to accredited investors only.[19] The SEC must ensure that accredited investors can fend for themselves, when presented with private investment opportunities which tend to be more risky than public offerings.

In 1980, Congress defined an accredited individual investor as "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulation which the Commission shall prescribe."[20] The current definition of an accredited investor, which has gone largely unchanged since its adoption in 1982, is contained in Rule 501 and contains the following categories:

- Individuals who have earned income exceeding $200,000 (or $300,000 combined with their spouse or spousal equivalent) for the past two years and has a reasonable expectation of reaching the same income level in the current year;
- Individuals with a net worth exceeding $1 million, or joint net worth with that individual's spouse or spousal equivalent that exceeds $1 million, excluding the individual's primary residence;
- Any private business development company;
- Any director, executive officer, or general partner of the issuer of the securities or of a general partner of the issuer;
- Organizations described in Section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000;
- Any trust with total assets in excess of $5,000,000;
- Any bank or loan association, as defined by the Securities Act of 1933;
- Any entity in which all of the equity owners are accredited investors;
- Individuals holding in good standing professional certifications, designations, or credentials that the Commission has designated as qualifying the individual for accredited investor status;
- Knowledgeable employees;
- Family clients and Family offices, as defined by the Investment Advisers Act.[21]

This current definition allows for issuers to have certainty in determining whether or not investors are accredited, which promotes capital formation.[22] This certainty is important given the 35 non-accredited investor limit in Rule 506(b) offerings and the prohibition against non-accredited investors participating in Rule 506(c) offerings.[23]

Issuers must verify that the investors they are raising capital from are accredited, in both Rule 506(b) and 506(c) offerings. However, this verification process is different depending on whether the offering is issued under the 506(b) exemption or the 506(c) exemption.[24] In a Rule 506(b) offering, an issuer merely needs to "reasonably believe" that an investor is accredited.[25] Yet in a 506(c) offering, the issuer must take "reasonable steps to verify" that purchasers are accredited investors.[26] These reasonable steps can differ depending whether the purchaser is accredited based on income or net worth.[27] Additionally, under Rule 506(c), the issuer must obtain written confirmation from one of the following entities, (1) a registered broker-dealer, (2) a SEC registered investment adviser, (3) a licensed attorney, or (4) a certified public accountant, that the entity has taken reasonable steps to verify the purchaser's accredited investor status within the past three months and determined that the investor is accredited.[28]

The accredited investor definition is critical to the functioning of the SEC's private offering framework. This is because the two most utilized exemptions to the Securities Act's registration requirements are either limited entirely to accredited investors or are limited to accredited investors and 35 non-accredited investors.[29] However, this definition is outdated and is both under-inclusive and over-inclusive in designating accredited investors. The accredited investor definition should be amended by indexing the current financial thresholds to better account for inflation and by adding two licensing exams in addition to the existing accredited investor framework. These changes would serve to better protect investors while still promoting capital formation.

II. BACKGROUND AND PROS/CONS OF THE ACCREDITED INVESTOR DESIGNATION

The Supreme Court, in *Securities and Exchange Commission v. Ralston Purina Co.*, explained that "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"[30] The SEC, in an attempt to limit offerees to individuals who can fend for themselves, passed Rule 146 in 1974.[31] Rule 146 limited private offerings to individuals who were either "sophisticated" or "wealthy."[32] In this context, Rule 146 defined sophistication as possessing sufficient knowledge and experience in financial and business matters to adequately evaluate the merits and risks of investments.[33] An investor was deemed "wealthy" when it was determined that an investor possessed the financial capacity to be able to bear the economic risk of the investment.[34] Additionally, Rule 146 placed the burden on issuers to evaluate the sophistication and wealth on individual investors.[35]

Issuers were extremely concerned with possible liability for misclassifying an individual as smart or rich enough to "fend for themselves," without objective and verifiable standards.[36] The lack of objective standards identifying which investors could participate in private offerings hindered the ability of businesses to raise capital.[37] Rule 146's requirements were so expensive and difficult to comply with that the exemption was practically unavailable, particularly for small offerings by small issuers.[38] Further, smaller issuers seeking small amounts of capital were more likely to go to investors whose sophistication under Rule 146 was questionable.[39] This was especially concerning to issuers because there was not an equivalent to the current Rule 508 of Regulation D.[40] As a result, mistakenly selling to even one buyer not meeting the standards of sophistication or wealth could result in the entire exemption being lost.[41] Given these concerns, the SEC replaced Rule 146 with Regulation D in 1982, which contained the accredited investor definition, with the goal of creating objective standards that promoted certainty for private issuers raising capital.[42]

A. Issues with the Current Definition

The current accredited investor definition allows a number of individuals to qualify as accredited solely based on meeting financial thresholds, and a number of these investors are unable to fend for themselves in private offerings. Additionally, the current definition prevents a number of sophisticated investors from participating in private offerings due to a lack of available avenues for investors to qualify as accredited based on their sophistication.

I. Outdated Financial Thresholds: Over-Inclusive

The financial thresholds contained in the accredited investor definition have not changed since its implementation in 1982.[43] Since 1982, there has been significant inflation and the economic landscape of the country has changed drastically over that time.[44] At the time of the definition's inception, approximately 1.5 million households, or 1.8% of households in the country qualified as accredited, but in 2019 over 16 million, or 13%, of households meet the financial requirements to be an accredited investor.[45] Further, since 1982, the United States has experienced inflation of 194%.[46] Had the financial thresholds been increased at the same rate as inflation, an accredited investor would need to earn $588,000 annually or have a net worth of $2.94 million to qualify as accredited.[47] Instead, the current financial thresholds remain unchanged, and investors are deemed accredited based on either having $200,000 annual income or a net worth of one million dollars, excluding the value of their primary residence.[48]

Leaving financial thresholds unchanged for 40 years is inconsistent with the stated goal of limiting private offerings to those who can "fend for themselves." This issue has been recognized by the SEC and Congress, with revisions being proposed in 2007 to index the financial thresholds to inflation every five years.[49] The largest issue with the unchanged financial thresholds is that it makes the accredited investor definition over-inclusive.[50] This results in many individuals qualifying as an accredited investor but have "little to no ability" to assess or be able to bear the risks of private offerings.[51] It is hard to believe that the amount of money needed to adequately bear the risk of investing in private offerings has gone unchanged in the past 40 years.

For example, many more elderly individuals now qualify as accredited investors than would have if the thresholds were indexed to match inflation. Individuals who have made modest contributions to retirement over a 50 year period will have likely accumulated over $1 million in retirement assets.[52] While these individuals have been financially prudent in saving for their retirement, they have experience in saving, not experience in managing investments in a way that could prepare them to fend for themselves in the private offering market.[53]

Under the Section 4(a)(2) exemption, investors need to possess or have access to the same type of information that would be contained in a registration statement.[54] Once it is settled that the offeree has access to this information, the sophistication of the offeree comes into play in determining if the prospective purchaser can fend for themselves.[55] However, this is not the case in Regulation D offerings, where accredited investors are irrefutably presumed to be financially sophisticated. Using wealth or income as a proxy for actual financial sophistication is an extremely troublesome method of classification. The lack of actual sophistication requirements for accredited investors, paired with the unchanged financial thresholds, have resulted in a number of individuals being deemed accredited investors who cannot fend for themselves in private offerings.[56]

The notion of indexing financial thresholds to inflation has broad support: including among investors, industry groups, state regulators, academics, crowd-funders, and SEC staff.[57] It is surprising that the thresholds have not been amended given this

broad coalition of support. One of the arguments made against indexing the financial thresholds to inflation is that this would reduce the capital available in private offerings.[58] The balancing of investor protection and encouraging capital formation is a common theme in the discourse surrounding the accredited investor definition, and something the SEC is constantly trying to manage.

However, the amount of capital being raised in the private markets has grown precipitously, having passed the amount of capital raised in the public market.[59] While updating the financial thresholds to match inflation would certainly lower the capital available in the private market, it is unlikely that this decrease would endanger the market given the vast increases in private capital raised in recent years.[60] The failure to update the financial thresholds to keep pace with inflation is inconsistent with the notion that private offerings should be limited to those who can fend for themselves, this issue must be remedied to better protect investors in the private market.

The SEC's current accredited investor definition is outdated and over-inclusive because it includes classes of individuals that are presumed sophisticated enough to evaluate the risks inherent in private investment opportunities. However, in the hypothetical presented above, an individual who has been making modest contributions to their retirement account over a period of 50 years will likely meet the financial thresholds, but this does not in any way reflect their ability to evaluate the risks associated with private offerings. This type of situation has occurred with some frequency, with the vulnerability of elderly accredited investors becoming a concern for the SEC.[61]

II. The Definition is Under-Inclusive

Under the current accredited investor definition, there are limited avenues for individuals to become accredited based on sophistication, professional qualifications, and education.[62] Currently, the avenues to become an accredited investor through sophistication include: Series 7, Series 65, and Series 82 Licenses, being a family client, as defined under the Investment Advisers Act of 1940, of a family office that itself qualifies as an accredited investor, and knowledgeable employees of a private fund where the investment is in the private fund.[63] Financially sophisticated individuals may be treated as unaccredited under the current definition, while someone who is wholly unfamiliar with the risks of private offerings can be accredited solely based on wealth or income.[64]

Critics of the current definition have argued that regulators should take into account education, years of investment experience, and the types of trades an investor has experience in.[65] However, these criteria are not perfect indicators of sufficient sophistication to protect oneself in the private offering marketplace.[66] One possible solution, that will be discussed in more depth later in the paper, is to administer a licensing exam to qualify investors as accredited.[67] Exams are regularly utilized by other government agencies. The Federal Communications Commission requires an exam to operate an amateur radio and the Federal Aviation Administration requires pilots to pass an exam.[68] Additionally, the SEC should publicize the information tested on the exam, and preparation courses would certainly be created to prepare investors for the exam.[69] This would serve to filter out investors who are not capable of fending for themselves, and increase knowledge in the private offering marketplace.[70]

B. What the Accredited Investor Definition Does Well

The current accredited investor definition does have some redeeming qualities, specifically, it provides certainty to issuers in verifying investors as accredited and promotes capital formation.

I. Increased Certainty and Promotes Capital Formation

The current accredited investor definition, and Regulation D as a whole, is favored among issuers because it brings certainty to private offerings.[71] This allows issuers to more reliably determine and verify whether investors qualify as accredited or non-accredited based on objective criteria.[72] This is evident based on the popularity of the Regulation D exemptions among both issuers and investors.[73] There have been several proposed changes to the current accredited investor definition; however, these changes have not been implemented partly because of the fear that it will negatively impact capital formation.[74]

As is illustrated in the verification section above, the current definition of accredited investors makes it extremely straight-forward to identify and verify investors as accredited investors. This is consistent with the SEC's goal in passing Regulation D, to bring certainty to the private offering context so that issuers can are able to confidently identify investors

that may participate in private offerings.[75] The current definition provides a far greater degree of certainty than its predecessor, Rule 146, which left investors with a low level of certainty as to which investors should be classified as accredited.[76]

As mentioned earlier, it is undeniable that the current accredited investor definition is excellent for capital formation, given that more money is raised through private offerings than is raised through public offerings.[77] In both 2018 and 2019, the amount raised through the Rule 506(b) exemption alone exceeded the amount raised through public offerings.[78] This is due in large part to the lack of disclosures required to be given to accredited investors and the ease with which potential investors can be identified and verified by issuers as accredited. Additionally, the over-inclusiveness of the current accredited investor definition serves to create more possible sources for issuers to raise capital from. While the current accredited investor definition is flawed in several ways, it is excellent for providing certainty to issuers and allows for an immense amount of capital to be raised more easily than through public offerings.

III. THE STRUGGLE IN BALANCING CAPITAL FORMATION AND INVESTOR PROTECTION

The strengths and weaknesses of the current accredited investor definition are directly tied to the SEC's longtime struggle in effectively balancing both capital formation and investor protection. A prime example of this is the refusal of the SEC to index the financial thresholds of accredited investors to match inflation.[79] By leaving the thresholds unchanged since 1982, the amount of individuals that qualify as accredited investors has increased dramatically.[80] Therefore, there are far more potential investors that can invest and contribute to companies' capital raising efforts.[81] The SEC has prioritized capital raising over investor protection in this regard, as raising the thresholds would more accurately limit accredited investors to those who can fend for themselves.

This prioritization of capital formation by the SEC was a driving force behind the SEC's passage of Regulation D. Since the adoption of the accredited investor definition, the SEC has sought to continue encouraging capital formation, and as a result has refused to meaningfully update the accredited investor definition. The initial rules governing private offerings, such as Rule 146, placed a greater weight on investor protection, but this was at the expense of capital raising.[82]

To that end, minimal changes have been made to the accredited investor definition and these changes have served to increase the efficiency of capital formation in private offerings. A series of amendments to the accredited investor definition were passed in 2020.[83] These amendments added categories to the accredited investor definition, including: those possessing specified professional certifications, knowledgeable employees, family clients of family offices, and created several categories for entities to qualify as accredited investors.[84] These changes do not necessarily compromise investor protection, but it is telling that the notably few changes that have ever been made to the accredited investor definition have served to increase capital formation. Since the adoption of the accredited investor definition, the SEC has sided strongly on the side of capital formation. Going forward the SEC needs to have a more balanced approach that both encourages capital formation and protects investors.

IV. PROPOSALS TO AMEND THE ACCREDITED INVESTOR DEFINITION

A. Index the Financial Thresholds to Better Account for Inflation and Take Liquidity Into Account

One possible solution is to update the current accredited investor definition by indexing financial thresholds to better account for inflation that has occurred since its adoption in 1982. This would help to ensure that individuals that qualify as accredited are more capable of taking on the risk associated with private market investments. As stated earlier, the current thresholds have gone largely unchanged over the past 40 years,[85] besides the modification to exclude the value of the investor's primary residence from the calculation of net worth.[86] Additionally, under the current framework an investor's net worth calculation could be based entirely on liberally appraised illiquid assets or on the assets of their spouse.[87]

As stated above, the SEC has removed a person's primary residence from the net worth calculation but has not done so for other illiquid assets.[88] As a result, it is possible for an investor to be accredited solely by income, but the investor can still be insolvent at the time of the purchase.[89] To remedy this, the SEC should impose liquidity requirements in addition to raising the financial thresholds under this requirement. These liquidity requirements should include the exclusion of irreplaceable assets, such as retirement accounts from the accredited investor calculation.[90] This would better ensure that individuals qualifying as accredited through financial means can financially bear the risk of their investment.

Proponents of indexing the financial thresholds to inflation argue that this helps protect investors by ensuring that they are in a financial position to bear the risk of investment.[91] One of the main critiques of this proposal is the likely negative effect it will have on capital formation.[92] Investors with high risk tolerance that do not meet the current financial thresholds may be unable to participate in private offering investments, despite possessing sufficient financial expertise to make sound investment decisions.[93] More individuals will be prevented from participating in private offering investments if the financial thresholds are indexed to account for inflation.

Another concern of critics is the rate at which the financial thresholds will be changed to account for inflation. There is fear that altering the financial thresholds to account for 40 years of inflation all at once would have a "disruptive" effect on the market, given the popularity of the Regulation D exemptions under the current thresholds.[94] This is because the number of potential investors would drop substantially if the thresholds were immediately indexed to current inflation rates.[95] Critics believe that this could prevent many smaller issuers from being able to raise capital in the private offering market.[96] However, the idea of adjusting the current thresholds to inflation rests on the assumption that the thresholds when enacted in 1982 were correct identifying the point at which investors can bear the risk of investing in private offerings.[97]

Proponents of altering the financial thresholds argue that the SEC is not limited to an all or nothing approach and can raise the financial thresholds without accounting for all 40 years of inflation immediately.[98] Additionally, the SEC should conduct a thorough economic analysis of the impact that raising the current financial thresholds would have on issuer's abilities to raise capital and how it would increase investor protection.[99] Further, the SEC should review any increase to the financial thresholds every two years to ensure that changes to the thresholds are not overly detrimental to an issuer's ability to raise capital through private placement.

This proposal would be an improvement over the existing framework that includes outdated financial thresholds. However, it is hard to imagine the SEC finding the "magic number" for financial thresholds that accurately reflects financial sophistication. This is because wealth is an imperfect proxy of financial sophistication and is not compatible with the Supreme Court's intention to limit private markets to those who can fend for themselves.[100] Because of this, the proposal to increase the financial thresholds to account for inflation, while an improvement over the current system, is not the best method for protecting investors while promoting capital formation. This proposal focuses on the over-inclusive aspects of the current accredited investor definition but fails to address the under-inclusive aspects and may actually exacerbate these effects.

B. Remove the Financial Thresholds and Rely on Investor Sophistication

Another possible solution is to remove the financial thresholds from the accredited investor definition entirely and rely on investor sophistication. Given the issues with using wealth as a proxy for sophistication, removing it altogether could be worthwhile. This proposal is more in line with protecting investors and limiting private market investment to those who can fend for themselves but does poorly on providing certainty to issuers and encouraging capital formation. This is because there is not currently a sufficient objective standard for determining that potential investors are sufficiently sophisticated to qualify as accredited. This proposal is similar to the SEC's approach prior to Regulation D. As explained above, the avenues to become an accredited investor through sophistication are limited, including only: Series 7, Series 65, and Series 82 Licenses; or be a family client, as defined under the Investment Advisers Act of 1940, of a family office that itself qualifies as an accredited investor.[101]

The SEC would need to add additional ways for investors to qualify as accredited through proving their sophistication for this approach to be viable. These avenues for becoming accredited through sophistication could include: professional experience, investment experience, and an objective exam to qualify as an accredited investor.[102] These additional categories of accredited investors would help to offset the loss of potential investors from eliminating the financial qualifications.

If the SEC were to eliminate the financial thresholds without creating additional methods to achieve accredited investor status through sophistication, this would have a materially adverse effect on the market.[103] Additionally, creating objective standards would prevent the SEC from facing similar issues they faced prior to passing Regulation D, under Rule 146. Issuers prefer the certainty of Regulation D and do not want to have to make borderline calls on investors accredited status.[104] Issuers' concerns might be less than they were under Rule 146, given the passage of Rule 508 of Regulation D, but the lack of certainty would still negatively affect capital formation.[105]

This proposal is extremely strong on investor protection but would very likely harm issuers ability to raise capital. This would largely depend on the objective standards created by the SEC to allow investors to become accredited by sophistication. This proposal could face similar criticism to Regulation D's predecessor, Rule 146, and be plagued by issuers uncertainty as to whether their investors are accredited or not. This proposal would be a wholesale change to the way the SEC has viewed regulating private offerings, and is unlikely to be a realistic route, due to the impact it could have on capital available to issuers in the private market.

C. Abandon the Accredited Investor Definition Entirely

Another alternative is to eliminate the accredited investor category altogether, given the difficulties in determining individuals who are capable of fending for themselves. Additionally, critics of the accredited investor definition lament that non-accredited investors are largely excluded from attractive private market investment opportunities.[106] Further, this preclusion of non-accredited investors arguably reduces the autonomy of non-accredited investors by prohibiting them from participating in private market investing to a larger extent.[107] This proposal rests on the notion that using sophistication and wealth alone as a proxy for determining if an investor can fend for themselves is not adequate.[108]

Additionally, the primary consideration in evaluating an investor's ability to fend for themselves is their access to registration type information.[109] Andrew Vollmer believes that the Court's opinion is *Ralston Purina* has been misinterpreted and misapplied; sophistication came into play when the offeree was given access to registration information but did not receive actual disclosure of information.[110] The ability to fend for oneself was never determined by wealth or the ability to withstand a financial loss.[111] An individual having the financial capacity to sustain a loss does not mean the individual can fend for oneself; it merely means that they are financially well off enough to withstand the consequences of not being able to fend for themselves.

Vollmer believes the SEC's current application of the accredited investor definition is used in a paternalistic way to protect investors from risky investments.[112] Instead, he believes that the focus of the SEC should be on the truthful and complete disclosure of information to prospective investors.[113] The accredited investor definition has allowed for opportunities to be limited to those deemed wealthy or sophisticated enough under the current definition.[114] The argument centers on the SEC's primary role being to ensure that information is fully disclosed to investors as opposed to a paternalistic role of picking and choosing which investors are in need of the SEC's protections.[115]

Additionally, removing the accredited investor definition entirely could have several benefits to issuers. Currently, issuers must have a reasonable belief or must take reasonable steps to verify that a purchaser is an accredited investor.[116] Complying with these verification requirements requires issuers to expend time and money, and there is the possibility that issuers could lose their exemption if mistakes are made in verifying purchasers accredited status.[117] If all individuals were eligible to be purchasers in private offerings, the verification costs of issuers would be zero. Further, issuers would have an even greater amount of sources to raise capital from, as any individual would be free to invest in private offerings.

There is case law to support the idea that investors must have access to the type of information that registration would disclose to sustain a private offering exemption.[118] The 5th Circuit in *Doran v. Petroleum Mgmt. Corp.*, stated that the cornerstone of the federal securities regulatory structure is disclosure and discussed financial sophistication.[119] However, it is important to note that *Doran* was decided in 1977, which is several years prior to the creation of the Accredited Investor definition by the SEC in 1982. Instead, the 5th Circuit in *Doran* was interpreting the Supreme Court's decision in *Ralston Purina*.[120] The SEC came to an entirely different interpretation of *Ralston Purina* than the 5th Circuit when it adopted the current accredited investor definition, which focuses largely on deeming investors accredited based on financial thresholds.[121]

The proposal to remove the accredited investor definition entirely is very weak on investor protection but promotes certainty as issuers would have no verification costs. However, issuers would still have compliance costs associated with furnishing registration type information to investors under this proposal. The SEC should give more weight to investor sophistication and not less, simply providing registration type information to investors does not ensure that they are able to fend for themselves. While there likely should be additional disclosure by issuers in private offerings, there still needs to be additional guardrails in place for investors to ensure that even when provided such information, each investor has "sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment."[122]

D. Licensing Exams to Earn Accredited Status

One alternative that both the SEC and scholars have discussed is the concept of implementing a licensing exam to qualify investors as accredited. As discussed earlier, there are only a few professional licenses currently accepted by the SEC for purposes of qualifying investors as accredited.[123] Any potential exam should test to ensure that investors are cognizant of the risks associated with unregistered offerings, and require the investor to display a general understanding of financial and investing concepts.[124] Unlike arbitrary financial thresholds, licensing exams would be a superior method of evaluating an investor's ability to fend for himself or herself in the private offering marketplace.

There are several suggestions on how a licensing exam should be administered: the primary difference in proposals is whether this would replace the current accredited investor definition, or supplement the current definition and provide additional avenues for investors to be deemed accredited. Wallis Finger suggested having two separate licensing exams, one exam for investors who are unaccredited under the current definition and one exam for investors who are accredited, based on meeting financial thresholds, under the current definition.[125] Finger proposes a less stringent exam for those accredited investors who are deemed accredited based on net worth or income.[126] Meanwhile, unaccredited investors would face a more difficult exam because they do not have the finances to allow for the same margin of error.[127]

Meanwhile, Blake Delaplane proposes creating an accredited investor licensing exam containing portions of existing financial exams as an additional avenue for deeming investors accredited.[128] This proposal would promote capital formation, as it would be extremely easy for investors to verify which investors are accredited through the licensing scheme and which are not.[129] This would be consistent with the SEC's history of prioritizing capital formation, and it would also serve to better protect and prepare investors to participate in private offerings. Additionally, the amount of capital available to issuers is increased in comparison to licensing schemes that eliminate the financial thresholds as avenues for investors to become accredited.

The SEC has solicited comments in the past regarding implementing a licensing examination as an avenue for investors to qualify as accredited.[130] All of the commenters, besides one, supported the recommendation.[131] However, a number of commenters expressed concern over the workability of administering such an exam, questioning the ability of an exam to measure financial sophistication and account for industry and investment experience.[132] Additionally, commenters have questioned the demand for an exam like this, and whether demand would justify incurring the costs associated with administering such an exam.[133]

Congress itself has seemingly grown tired of the SEC's unwillingness to amend the accredited investor definition and proposed its' own expansion of the accredited investor definition in the Fair Investment Opportunities for Professional Experts Act (FIOPEA).[134] The proposed exam planned to specifically cover: "(1) The different types of securities, (2) The disclosure obligations under the securities laws of issuers versus private companies, (3) The structures of corporate governance, (4) The components of a financial statement, (5) Other criteria the Commission shall establish in the public interest and for the protection of investors."[135] Additionally, Jeff Thomas has suggested that exams should ensure investors are able to spot common risk factors and show that they are aware when to seek professional help.[136] However, the FIOPEA proposed by the House of Representatives was never passed by the Senate.[137] The addition of licensing exams should strongly be considered by the SEC as these exams serves to encourage both capital formation and protects investors.

E. Investment Limits

The SEC could seek to provide guardrails to investors by creating caps on the amount that purchasers, both accredited and non-accredited, can invest over the course of a 12 month period, given the risks associated with private offerings. Investment caps have been implemented by the SEC in the context of Regulation Crowdfunding (Regulation CF). In Regulation CF offerings, investors are limited in the amount they can invest over a 12 month period based upon each investor's net worth and income.[138] Investors with either net worth or annual income less than $107,000 are limited to the investing the greater of $2,200 or 5% of the greater of their annual income or net worth over a 12 month period.[139] While individuals whose annual income and net worth are equal to or greater than $107,000 are limited to investing over a 12 month period the greater of 10% of their annual income or net worth, not to exceed $107,000.[140]

The SEC has previously considered providing investment limits to non-accredited investors and to investors qualifying

through professional credentials.[141] However, the SEC rejected implementing such limits because of the effect these limits would have on capital formation.[142] The proposal to limit investors who qualify through professional credentials was also rejected because the ability to sustain a loss is irrelevant once the investor is deemed to have sufficient financial sophistication to fend for himself or herself.[143] Limiting the amount of securities that unaccredited investors can purchase would have limited effect, given that the overwhelming majority of capital is raised through the Rule 506(b) exemption, which already limits the number of non-accredited purchasers that may participate in the offering.[144]

It is highly unlikely that investment limits applying to both accredited and non-accredited investors would ever be accepted by the SEC in the context of Regulation D private offerings given the effect it would have on capital formation. Once an investor is deemed accredited they should be able to invest the amount they are comfortable with, and the focus of the SEC should be on regulating the process by which individuals are deemed accredited.

F. Chosen Proposal and Reasoning

The SEC should implement two licensing exams, one for investors accredited under the current definition and one for investors that are non-accredited under the current definition. Additionally, the SEC should perform a thorough analysis to determine new financial thresholds that better account for the past 40 years of inflation.[145] These two changes to the current accredited investor regulatory framework would better allow investors to fend for themselves while still promoting capital formation and certainty. Further, this framework would allow for additional sources of capital to be available to issuers, by allowing more investors to become accredited based on their sophistication.

As discussed above, the test for current accredited investors would be less stringent than the test for investors that are currently non-accredited. The reason for this is two-fold, first, this exam would ensure minimum competency and financial understanding without detrimentally affecting the current capital available to issuers. Secondly, the proposal is less likely to face strong opposition if current accredited investors are unlikely to lose their accredited status.[146] However, this proposal still eliminates investors from receiving a free pass to accredited status solely based on meeting financial thresholds.[147]

This proposal also fixes, to a large extent, the under-inclusive nature of the current accredited investor definition. Non-accredited investors can qualify as accredited by taking and passing the exam for non-accredited investors. Individuals with a wealth of knowledge from experience, education, or other sources would be able to participate in the private offering marketplace under this proposal. Additionally, the presence of an exam would lead to the creation of preparation materials and preparation courses.[148] Investors would be better informed and more capable of fending for themselves just based on preparing for the exam.

The current financial thresholds should be adjusted to better account for inflation. The SEC should conduct an economic analysis to determine an amount that best reflects an investor's ability to fend for himself or herself, without blindly adjusting the thresholds set in 1982 to current inflation. However, many of the concerns critics have about altering the financial thresholds would be ameliorated by having a licensing exam available to both accredited and non-accredited investors. The only practical effect of not qualifying as accredited under this proposal would be a more stringent exam, which would better ensure that the investor is capable of fending for himself or herself. Yet, it is still important to determine the adjusted financial thresholds, because investors not deemed to have the financial capacity to bear the risk of their investment would need to pass the more challenging of the two licensing exams.

V. CONCLUSION

The current accredited investor definition is outdated and is both over-inclusive and under-inclusive as a result. It is incredibly important for the accredited investor definition to adequately protect investors while still encouraging capital formation. The importance of the accredited investor definition can hardly be overstated, because the two most popular private offering exemptions are limited either entirely or largely to accredited investors.[149] The SEC needs to better prioritize investor protection while still encouraging capital formation. It is critical to strike an effective balance, as over-correcting in favor of investor protection, much like in Rule 146, would negatively impact the private offering marketplace.

The options available to the SEC to update the accredited investor definition include: indexing the financial thresholds to account for inflation, remove the financial thresholds and rely on investor sophistication, abandon the accredited investor definition altogether, implement licensing exams, and impose investment limits on purchasers in private offerings. However,

none of these proposals, on their own, adequately address both the under-inclusive and over-inclusive nature of the current definition.

The SEC should implement two separate licensing exams, a separate exam for accredited and non-accredited investors, and index the current financial thresholds to better account for the past 40 years of inflation. The licensing exams address the under-inclusive aspects of the current definition by allowing investors additional avenues to qualify as accredited based on their sophistication. The licensing exams also address the over-inclusive aspects of the definition by requiring all investors who seek to participate in private offerings to display the requisite amount of financial knowledge to be able to fend for themselves. Additionally, gradually indexing the current thresholds to inflation addresses the over-inclusive nature of the definition by limiting the amount of individuals entitled to take the less stringent licensing exam.

Footnotes

[*] Trey Proffitt is an incoming associate Munsch Hardt Kopf & Harr, P.C.

[1] U.S. Securities and Exchange Commission, Registration Under the Securities Act of 1933, Investor.gov, https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933.

[2] Scott Bauguess et al., *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2017*, U.S. Securities and Exchange Commission 3 (Aug. 2018).

[3] Adam Hull & Rick Jordan, Securities Laws, TXCLE Advanced Business Law (2017).

[4] SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17956, 17957–58 (Mar. 31, 2020) (proposing release).

[5] *Id.*

[6] 15 U.S.C.A. § 77d(a)(2).

[7] Baugess, *supra* note 2, at 1, 2.

[8] SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17956, 17957 (Mar. 31, 2020) (proposing release).

9 Adam Hull, *supra* note 3.

10 *Id.*

11 Baugess, *supra* note 2, at 2.

12 *Id.*

13 SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17956, 17957 (Mar. 31, 2020) (proposing release).

14 *Id.*

15 Adam Hull, *supra* note 3.

16 *Id.*

17 Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, 126 Stat 306, § 201 (2012).

18 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).

19 17 C.F.R. § 230.506(b)(2)(i); 17 C.F.R. § 230.506(c)(2).

20 Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified as amended at 15 U.S.C. § 80 (2000)).

21 17 C.F.R. § 230.501(a)(1) to (8).

22 Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 739 (2009).

23 17 C.F.R. § 230.506(b)(2)(i);17 C.F.R. § 230.506(c)(2).

24 *Id.*

25 17 C.F.R. § 230.506(b)(2)(i) ("Limitation on number of purchasers. There are no more than, or the issuer reasonably believer that there are no more than, 35 purchasers of securities from the issuer in offerings under this section in any 90-calendar-day period.").

26 17 C.F.R. § 230.506(c)(2)(ii).

27 17 C.F.R. § 230.506(c)(2)(ii)(A) to (b) (explaining that for investors accredited on the basis of income, issuers can review any Internal Revenue Service Form that shows the purchaser's income for the two most recent years, and for net worth, issuers can review bank statements, brokerage statements, and other statements issued by third parties).

28 17 C.F.R. § 230.506(c)(2)(ii)(C).

29 *See* 17 C.F.R. § 230.506(b)(2)(i); 17 C.F.R. § 230.506(c)(2)(i).

30 Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

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32 *Id.*

33 *Id.*

34 *Id.*

35 Michael Finke & Tao Guo, *The Unsophisticated "Sophisticated": Old Age and the Accredited Investors Definition*, SEC (2019).

36 Paul, *supra* note 31, at 3.

37 H. David Heumann, *Is SEC Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings*, 55 Neb. L. Rev. 1, 4 (1975).

38 Rutherford B. Campbell Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919, 923–924 (2011).

39 *Id.*

40 *See id.*

41 *Id.*

42 *See* Paul, *supra* note 31, at 3.

43 Christopher R. Zimmerman, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 NW. U. L. REV. 507, 522 (2019).

44 *Id.*

45 *Id.*

46 U.S. Inflation Calculator, https://www.usinflationcalculator.com.

47 *See id.*

48 17 CFR 230.501(a)(5) to (6).

[49] Zimmerman, *supra* note 43, at 523.

[50] Commissioner Allison Herren Lee, *Statement on the Proposed Expansion of the Accredited Investor Definition*, Sec. & Exch. Comm. (Dec. 18, 2019).

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] Andrew N. Vollmer, *Abandon the Concept of Accredited Investors in Private Securities Offerings*, 49 Sec. Reg. L. J. 1, 16 (Spring 2021).

[55] *Id.* at 16–17.

[56] *See id.* at 17.

[57] Commissioners Allison Herren Lee and Caroline Crenshaw, *Joint Statement on the Failure to Modernize the Accredited Investor Definition*, Sec. & Exch. Comm. (Aug. 26, 2020).

[58] Vollmer, *supra* note 54, at 17.

[59] Lee and Crenshaw, *supra* note 57.

[60] *Id.*

[61] Commissioner Allison Herren Lee, *Remarks at the SEC Roundtable on Combating Elder Investor Fraud*, U.S. Sec. & Exch. Comm. (Oct. 3, 2019).

62 *See* 17 C.F.R. § 230.502.

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66 *Id.*

67 Finger, *supra* note 22, at 760, 761.

68 Choi, *supra* note 64, at 312.

69 *Id.*

70 *See id.*

71 Finger, *supra* note 22, 743.

72 *See* 17 C.F.R. § 230.506(b)(2)(i); 17 C.F.R. § 230.506(c)(2).

73 SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17956, 17957 (Mar. 31, 2020) (proposing release).

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76 Paul, *supra* note 31, at 2.

77 Baugess, *supra* note 2, at 1.

78 Vollmer, *supra* note 54, at 12.

79 Finger, *supra* note 22, at 748.

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81 *Id.*

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85 Securities & Exchange Commission, *Recommendation of the Investor Advisory Committee: Accredited Investor Definition*, SEC 1, 4 (Oct. 9, 2014).

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92 Blake W. Delaplane, Red, Yellow, or Green Light?: Assessing the Past, Present, and Future Implications of the Accredited Investor Definition in Exempt Securities Offerings, Va. L. & Bus. Rev. 329, 355 (2020).

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94 Securities & Exchange Commission, *Recommendation of the Investor Advisory Committee: Accredited Investor Definition*, SEC 1, 6 (Oct. 9, 2014).

95 Burton, supra note 74, at 7.

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98 Zimmerman, *supra* note 43, at 534.

99 *Id.* at 535.

100 Syed Haq, Revisiting the Accredited Investor Standard, 5 Mich. Bus. & Entrepreneurial L. Rev. 59, 69 (2015); Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

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102 Securities & Exchange Commission, *Recommendation of the Investor Advisory Committee: Accredited Investor Definition*, SEC 1, 7–8 (Oct. 9, 2014).

103 *See* Burton, *supra* note 74, at 7.

104 Paul, *supra* note 31, at 3.

105 *See* 17 CFR § 230.508 (Rule 508 provides that failure to comply with a term, condition or requirement of Rule 504 or Rule 506 will not result in loss of the exemption so long as: (1) the failure did not pertain to a term, condition, or requirement directly intended to protect that particular individual or entity; (2) the failure to comply was insignificant with respect to the offering as a whole; and (3) a good faith and reasonable attempt was made to comply with the terms of Rule 504 and Rule 506).

106 Vollmer, *supra* note 54, at 15.

107 *Id.*

108 Delaplane, *supra* note 92, at 362.

109 *Id.*

110 Vollmer, *supra* note 54, at 16.

111 *Id.* at 17.

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113 *Id.*

114 *Id.* at 7.

115 *Id.* at 6.

116 Vollmer, *supra* note 54, at 15.

117 *Id.*

118 Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 903 (5th Cir. 1977).

119 *Id.* at 904.

120 *See id.* at 902.

121 17 CFR § 230.501(a).

122 17 CFR § 230.506(b)(2)(ii).

123 *See* U.S. Securities and Exchange Commission, Amendments to Accredited Investor Definition (Mar. 29, 2021) (explaining that the SEC adopted amendments to the "accredited investor" definition on August 26, 2020, allowing for certain professional certifications to qualify an investor as accredited: Licensed General Securities Representative (Series 7)); Licensed Investment Adviser Representative (Series 65); and Licensed Private Securities Offerings Representative (Series 82).

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125 Finger, *supra* note 22, at 760, 761.

126 *Id.* at 761.

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132 *Id.*

133 Amending the "Accredited Investor" Definition, Securities Act Release 10,734, at 2580 Table 1.

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139 *Id.*

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142 *Id.*

143 *See id.*

144 Baugess, *supra* note 2, at 2.

145 Zimmerman, *supra* note 43, at 535.

146 Finger, *supra* note 22, at 761.

147 *Id.*

148 Choi, *supra* note 64, at 312.

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