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## Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act

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# UNSOPHISTICATED WEALTH: RECONSIDERING THE SEC'S "ACCREDITED INVESTOR" DEFINITION UNDER THE 1933 ACT

## I. INTRODUCTION

Paris Hilton almost certainly can purchase unregulated securities issued by hedge funds or other private investment vehicles. Although her training and sophistication in the field of high-stakes financial transactions may be limited, the Securities and Exchange Commission (the "SEC" or the "Commission") would leave her to her own devices if she chose to invest in private offerings. On the other hand, assume Sheryl has an M.B.A. from Harvard and is a graduate of one of the country's leading Ph.D. programs in financial systems analysis. After all of this schooling, Sheryl is long on debt and short on assets. She has several offers to work at the nation's most prestigious investment brokerages. But if Sheryl wants to invest in a private offering, the SEC regulations will not allow it. Sheryl is barred from investing in private offerings because, unlike Paris Hilton, Sheryl does not have sufficient income or net worth to be an "accredited investor." Though ironic, this hypothetical contrast demonstrates the current state of securities law in the United States. The apparent incongruity of this example warrants a closer examination of the SEC's accredited investor definition and raises the question: is there a better way?

The SEC regulates and oversees the purchase and sale of securities.<sup>1</sup> Under Section 4 of Securities Act of 1933 (the "1933 Act")<sup>2</sup> or Regulation D,<sup>3</sup> promulgated under the 1933 Act, certain securities offerings are exempt from registration requirements, so long as certain offering conditions are met.<sup>4</sup> One such condition is that investors participating in private offerings generally must be accredited.<sup>5</sup> Under the current definition, an accredited investor is one "whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase

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1. See generally LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* (4th ed. 2006).

2. 15 U.S.C. § 77d (2000).

3. Regulation D, 17 C.F.R. §§ 230.501–508 (2007).

4. *Id.* For information regarding the registration requirements for publicly offered securities, see *infra* notes 33–34 and accompanying text.

5. Rule 504, 17 C.F.R. § 230.504 (2007); Rule 505, 17 C.F.R. § 230.505 (2007); Rule 506, 17 C.F.R. § 230.506 (2007); see also *infra* note 57.

exceeds \$1,000,000,” or alternatively, one “who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years, [with] a reasonable expectation of reaching the same income level in the current year.”<sup>6</sup> Hedge funds, along with other private investment vehicles such as private equity funds, typically sell securities to accredited investors as one way of maintaining their exempt status.<sup>7</sup>

On December 27, 2006, the Commission released proposed revisions to its accredited investor definition.<sup>8</sup> The SEC drafted the proposed revisions with an eye toward providing additional investor protections in light of the increased number of investors who have achieved accredited investor status.<sup>9</sup> To meet this goal, the Commission proposed a new category of accredited investor called the “accredited natural person,” which would apply to persons transacting in private investment vehicles under Regulation D<sup>10</sup> and Section 4(6).<sup>11</sup> The Commission specified that the accredited natural person had to meet “either the net worth or income test specified in rule 501(a) or rule 215 [*sic*], as applicable, *and* [own] at least \$2.5 million in investments.”<sup>12</sup> In connection with its December 27, 2006,

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6. Rule 501(a), 17 C.F.R. § 230.501(a) (2007).

7. See *infra* notes 92–98 and accompanying text.

8. Rule 501(a), 17 C.F.R. § 230.501(a); Securities Act Release No. 33-8766, 72 Fed. Reg. 400 (proposed Jan. 4, 2007). In addition to proposed revisions to the accredited investor definition, the Commission also considered a new antifraud rule for investment advisers to pooled investment vehicles, which was unanimously adopted on July 11, 2007. See SEC Press Release 2007-133, SEC Votes to Adopt Antifraud Rule Under Investment Advisers Act (July 11, 2007), available at <http://www.sec.gov/news/press/2007/2007-133.htm>; Investment Adviser Act Release No. IA-2628, 72 Fed. Reg. 44756 (Aug. 9, 2007).

9. Release No. 33-8766, 72 Fed. Reg. 400.

10. Regulation D, 17 C.F.R. §§ 230.501–508 (2007).

11. Release No. 33-8766, 72 Fed. Reg. 400, 405. Section 4(6) is an exemption under the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a to 77bbbb (2000)), for

transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 77c(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer’s behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

15 U.S.C. § 77d(6) (2000). In Release No. 33-8766, the Commission noted that its proposed “[accredited natural person] definition would be the same for the purposes of section 4(6) and Regulation D private offerings.” Release No. 33-8766, 72 Fed. Reg. 400, 405 n.46.

12. Release No. 33-8766, 72 Fed. Reg. 400, 405 (emphasis added). Rule 215, 17 C.F.R. § 230.215 (2007), part of the General Rules and Regulations promulgated under the 1933 Act, mirrors the Rule 501(a) definition for a natural person who is an accredited investor. See Frank A. Taylor, Jeffrey D. Pflaum & Kevin C. Flesch, *The Issuance of Securities by Small and Growing Businesses: A Primer*, 22 WM. MITCHELL L. REV. 1375, 1399 n.112 (1996). An issuer seeking an offering exemption

release, the SEC issued a call for comments on the accredited natural person standard.<sup>13</sup> In response, the SEC received numerous comment letters,<sup>14</sup> both in support<sup>15</sup> and in opposition.<sup>16</sup>

On August 3, 2007, the Commission proposed additional revisions to the accredited investor definition.<sup>17</sup> The SEC's proposal included adding an "investments-owned standard" as an alternative means of establishing accredited investor status.<sup>18</sup> Under this investments-owned standard, individuals and spouses with \$750,000 in investments would be deemed accredited.<sup>19</sup> The SEC also continued to consider its proposed accredited natural person definition.<sup>20</sup> Similar to the earlier December 27, 2006, release, the Commission issued a call for comments and again received comment letters in support of<sup>21</sup> and in opposition to its proposal.<sup>22</sup>

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based on Section 4(6) under the 1933 Act would define "accredited investor" based on the definition in Rule 215. See Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They "Suitable" for the Retail Investor?*, 72 S. CAL. L. REV. 67, 76 n.39 (1998). For additional information on Section 4(6) exemptions, see *supra* note 11.

13. Release No. 33-8766, 72 Fed. Reg. 400.

14. As of June 2007, the Commission had received "several hundred comment letters on the proposals." Rita M. Molesworth, *SEC Proposes New Rules Directed At Hedge Funds And Their Advisers—Part II*, THE METROPOLITAN CORP. COUNS., June 2007, at 37.

15. See, e.g., Comment Letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association (Mar. 12, 2007), available at <http://www.sec.gov/comments/s7-25-06/s72506-584.pdf> ("We believe that updating qualification standards originally adopted in 1982 is appropriate and commend the Commission's efforts in this regard.")

16. See, e.g., Comment Letter from Matt Motley (Mar. 16, 2007), available at <http://www.sec.gov/comments/s7-25-06/s72506-605.htm> ("I am a commodity trader by profession who qualified under the previous rules but would miss the cut under the new rules. . . . I have no need to have the SEC save me from myself. This is elitist and completely unnecessary. Please reconsider.")

17. Securities Act Release No. 33-8828, 72 Fed. Reg. 45116 (proposed Aug. 10, 2007). In addition to the proposed revisions to the accredited investor definition relating to individuals and their spouses, the Commission proposed an "investments-owned" standard for entities and inflation adjustments to the dollar-amount thresholds in Rule 501 on a going-forward basis. *Id.* at 45117. The Commission also articulated a new proposed Rule 507, which would exempt offers and sales of securities only to "large accredited investors." Under the new proposed Rule 507, limited advertising would be permitted. *Id.* at 45117–18. In addition, the SEC proposed a "bad actor" disqualification rule, which would preclude habitual offenders from conducting private offerings for a certain period depending on the egregiousness of the conduct leading to the disqualification. *Id.* at 45130.

18. *Id.* at 45117.

19. *Id.* at 45123.

20. *Id.* at 45116.

21. *Id.*; see, e.g., Comment Letter from Karen Tyler, NASAA President and Commissioner (October 26, 2007), available at <http://www.sec.gov/comments/s7-18-07/s71807-57.pdf> ("NASAA supports the adoption of an 'investments-owned' element in the accredited investor definition. Such a test may more accurately assess whether an investor is presumptively financially sophisticated and capable of assuming the risk of an investment in a private securities offering.")

22. Release No. 33-8828, 72 Fed. Reg. 45116; see, e.g., Comment Letter from Sheldon M. Jaffe (Oct. 29, 2007), available at <http://www.sec.gov/comments/s7-18-07/s71807-59.pdf> ("The proposed amendment to Rule 501 will simply serve as an additional license for promoters to prey upon the elderly.")

In light of this disagreement among commentators over how to revise the current accredited investor definition, a reexamination of the definition is necessary. Reconsideration is also relevant given legal criticisms of the current standard,<sup>23</sup> as well as the perceived deficiencies in proposed scholarly alternatives to the current accredited investor definition.<sup>24</sup> Finally, the need for this review is heightened by the tremendous growth of the hedge fund industry over the past two decades<sup>25</sup> and the projection that hedge fund assets will likely exceed \$1 trillion in the next five to ten years.<sup>26</sup> This Note reexamines the current accredited investor definition and proposes a licensing scheme to supplement the current definition.

Part II of this Note provides a history of the 1933 Act, Regulation D and the accredited investor standard. Part II also details the need for change in the current accredited investor standard by explaining the evolving financial landscape, presenting scholarly criticisms of Regulation D, and examining proposed alternatives to the current definition. Part III surveys the problems with the current wealth-based accredited investor regime and details the shortcomings of existing scholarly alternatives.

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23. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000); C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081; Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994); Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975. See also *infra* notes 108–25 and accompanying text.

24. See Choi, *supra* note 23; Fletcher, *supra* note 23; Friedman, *supra* note 23; see also *infra* notes 126–59 and accompanying text.

25. According to estimates, “hedge fund assets grew from \$50 billion in 1993 to \$592 billion in 2003, an increase of 1084 percent.” SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 1 n.4 (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter SEC STAFF REPORT]. In addition to the tremendous growth of the industry’s assets, the number of hedge fund firms has also experienced significant growth: 3,307 firms in 2004, up 74 percent from 1,903 in 1999. Jenny Anderson & Riva D. Atlas, *If I Only Had a Hedge Fund*, N.Y. TIMES, Mar. 27, 2005, at B1.

In 2008, the American economy began experiencing a significant economic crisis, which some commentators have stated may be the “deepest crisis since the Great Depression.” Sheryl Gay Stolberg, *Leaders Move Toward Meeting on Economic Crisis*, N.Y. TIMES, Oct. 19, 2008, at A30. Amid the economic crisis, hedge funds have been doing comparatively better than their counterparts in the mutual fund industry, but the hedge fund industry has still experienced losses: approximately \$180 billion in losses during a three-month period in the summer and fall of 2008. Louise Story, *Investors Flee as Hedge Fund Woes Deepen*, N.Y. TIMES, Oct. 23, 2008, at A1. Further, as the economic crisis continues, many hedge fund investors are rushing to redeem their investments, which has led funds to sell large amounts of stock to meet investor redemption demands. *Id.* While the current economic crisis likely will have a significant impact on the hedge fund industry going forward, it is too early and beyond the scope of this Note to comment upon the potential effect of the economic crisis on hedge funds and hedge fund regulation.

26. SEC STAFF REPORT, *supra* note 25, at vii.

Ultimately, Part IV proposes a licensing scheme which would supplement the current accredited investor definition. This system incorporates two different licensing exams: one for those natural persons who are accredited investors under the current definition, and one for those natural persons who are currently unaccredited.

## II. BACKGROUND

### A. *The History of Regulation D*

Congress passed the 1933 Act in the aftermath of the Stock Market Crash of 1929, during the early years of the Great Depression.<sup>27</sup> With the 1933 Act, Congress attempted to regulate the offer and sale of securities, which previously had been regulated by a patchwork of state laws.<sup>28</sup>

The purpose of the 1933 Act, as stated in its preamble, is “[t]o provide full and fair disclosure of the character of securities sold in interstate commerce and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.”<sup>29</sup> The legislative histories of the 1933 Act and the Securities Exchange Act of 1934 (the “1934 Act”)<sup>30</sup> reflect concerns that investors participating in the financial markets were not sufficiently protected against inadequate disclosure, misrepresentation, and manipulative schemes.<sup>31</sup> Congress feared that if investors were victimized as a result of insufficient market safeguards, they would lose confidence in the financial markets.<sup>32</sup> The Commission attempted to implement safeguards to prevent loss of investor confidence

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27. See LOSS, SELIGMAN & PAREDES, *supra* note 1, at 254–57.

28. *Id.* at 233–34. For additional information on the inadequacy of state regulation prior to the enactment of the 1933 Act, see Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18–28 (1983).

29. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74.

30. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a to 78mm (2000)). While the 1933 Act is concerned with the offering process, the 1934 Act concerns secondary trading. The 1934 Act has four purposes: “to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation’s credit that goes into those markets.” LOSS, SELIGMAN & PAREDES, *supra* note 1, at 328.

31. S. REP. NO. 73-792, at 3–4 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Securities Exchange Act of 1934, Item No. 17 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

32. See 77 CONG. REC. S2919 (May 1, 1933), *reprinted in* LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, *supra* note 31, at Securities Act of 1933, Item No. 7.

and provide investors with adequate disclosure by implementing the mandatory use of registration statements for securities sold to the public.<sup>33</sup>

The 1933 Act delineates two types of securities offerings: public offerings and private offerings.<sup>34</sup> Public offerings of securities must be registered and approved by the Commission.<sup>35</sup> In contrast, certain private offerings of securities are exempt from the 1933 Act's registration requirements.<sup>36</sup> The 1933 Act's legislative history details that the private offering exemption allowed "an issuer to make a specific or an isolated sale of its securities to a particular person," and was directed at transactions "where there [was] no practical need for [the bill's] application or where the benefits [were] too remote."<sup>37</sup> Initially, exemptions were determined by examining a number of factors, such as the number of offerees and their relationship to each other and the issuer, the number of units offered, and the manner of the offering.<sup>38</sup>

In 1953, the Supreme Court decided *Securities and Exchange Commission v. Ralston Purina Co.*<sup>39</sup> The SEC brought suit against Ralston Purina because the company sold unregistered common stock to its employees.<sup>40</sup> Ralston Purina claimed that its employee stock sales were

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33. LOSS, SELIGMAN & PAREDES, *supra* note 1, at 327. The use of registration statements and prospectuses, which are given to the buyer and summarize the information in the registration statement, were included as investor safeguards in the 1933 Act. See William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 183 (1933). For an early critique of the 1933 Act's use of disclosure as an investor safeguard, see William O. Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 521 (1934).

Today, registration statements are governed by Regulation C of the 1933 Act, and generally include information about the company's business, the security offered, the company's management, and the company's financial statements. See 17 C.F.R. §§ 230.401–479 (2007). The purpose of registration statements is to permit investors, not the Commission, to make informed judgments about purchasing securities. SEC, *The Laws That Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml> (last visited Dec. 22, 2008). Registration statements are available publicly through the Commission's EDGAR database on its website ([www.sec.gov](http://www.sec.gov)). See SEC, *SEC Filings and Forms*, <http://www.sec.gov/edgar.shtml> (last visited Dec. 22, 2008).

34. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a to 77bbbb (2000)).

35. For a general overview of the public offering process, see William K. Sjoström Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 556–65 (2006).

36. Regulation D, 17 C.F.R. §§ 230.501–508 (2007).

37. H.R. REP. NO. 73-85, 15–16 (May 4, 1933), as reprinted in LOSS, SELIGMAN & PAREDES, *supra* note 1, at 1363.

38. LOSS, SELIGMAN & PAREDES, *supra* note 1, at 1363–65; see also 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, 624 (1974).

39. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

40. *Id.* at 121.

exempt because the offerees were key employees.<sup>41</sup> The Court recognized that the private offering exemption was ill-defined and attempted to clarify its scope.<sup>42</sup> The Court looked to the 1933 Act's legislative history regarding the private offering exemption, and held that "[s]ince exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act."<sup>43</sup> After *Ralston Purina*, a private offering was "[a]n offering to those who are . . . able to fend for themselves."<sup>44</sup>

In the 1970s, financing via private offerings expanded,<sup>45</sup> and the SEC and the judiciary struggled with the practicality and efficiency of determining investor suitability on a case-by-case basis.<sup>46</sup> In response, the SEC enacted Rule 146 in 1974 to create an objective means to determine investor suitability.<sup>47</sup> Under Rule 146, an issuer had to meet three requirements for an offering to be exempt from registration requirements.<sup>48</sup> First, the issuer had to have a reasonable belief that the offeree was sophisticated, which was generally demonstrated by wealth or knowledge.<sup>49</sup> Second, prior to completion of the sale, the issuer had to have a reasonable belief that the purchaser could assess the risks and merits of the offer, or that the purchaser had consulted a financial advisor and could bear the financial risks of the offer.<sup>50</sup> Third, the issuer had to provide the offeree with the type of information that would be provided in a registration statement.<sup>51</sup>

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41. *Id.*

42. *Id.* at 122.

43. *Id.* at 125 (internal citations omitted).

44. *Id.*

45. Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 274–25 (1990).

46. See, e.g., SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); Henderson v. Hayden Stone Inc., 461 F.2d 1069 (5th Cir. 1972); Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). One commentator noted that due to judicial uncertainty in the area of private offering exemptions, "reliance on the . . . exemption [was] a calculated business risk at best." Julian M. Meer, *The Private Offering Exemption Under the Federal Securities Act – A Study in Administrative and Judicial Contraction*, 20 SW. L.J. 503, 512–13 (1966).

47. Securities Act Release No. 33-5487, 4 SEC Docket 154 (Apr. 23, 1974).

48. Fletcher, *supra* note 23, at 1122–23. For more information on the Rule 146 requirements, see Alberg & Lybecker, *supra* note 38, at 633–34.

49. Fletcher, *supra* note 23, at 1122.

50. *Id.* at 1122–23.

51. *Id.* For more information detailing what information must be included in a registration statement, see *supra* note 33.



Rule 146 was not the panacea that the Commission hoped it would be.<sup>52</sup> The rule resulted in compliance problems for small issuers who were uncertain whether the private offering exemption was available,<sup>53</sup> primarily because investor suitability was determined by subjective criteria.<sup>54</sup>

In 1980, the SEC replaced Rule 146 with Rule 242.<sup>55</sup> With the promulgation of Rule 242, the Commission intended to reduce the uncertainty of the offering exemption by implementing an objective means to determine investor suitability.<sup>56</sup> Under Rule 242, issuers only needed to establish that a purchaser was an “accredited natural person” to exempt the offering from registration requirements.<sup>57</sup> The Commission defined an accredited natural person as “any bank of the type whose securities are exempt from registration under the Securities Act of any insurance company, any registered investment company, or any Small Business Investment Company licensed by the Small Business Administration.”<sup>58</sup>

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52. Securities Act Release No. 33-6121, 18 SEC Docket 287, 289 (Sept. 11, 1979).

53. *Id.*; see also Alberg & Lybecker, *supra* note 38, at 635–36 (foreseeing some of the potential problems for issuers, especially small issuers, under Rule 146).

54. Many commentators at the Commission’s small business hearings complained that under Rule 146, they were forced to make “subjective determination[s] as to the sophistication of each offeree and each purchaser.” Securities Act Release No. 33-6180, 19 SEC Docket 295, 297 (Jan. 17, 1980).

55. *Id.*

56. *Id.*

57. *Id.* Under Rule 242, the exemption from registration requirements was applicable to offers to an “unlimited number of ‘accredited natural persons’” and no more than “35 other purchasers.” *Id.* at 295. This is similar to Rules 505 and 506 under Regulation D, which limit the number of unaccredited purchasers in an exempt offering to thirty-five. Rule 505, 17 C.F.R. § 230.505 (2007); Rule 506, 17 C.F.R. § 230.506 (2007). Under Rule 505, there is no requirement that purchasers be sophisticated. 17 C.F.R. § 230.505. In contrast, under Rule 506, an issuer must reasonably believe that the unaccredited purchasers participating in the offering have “knowledge and experience in financial and business matters” and are “capable of evaluating the merits and risks of the prospective investments.” 17 C.F.R. § 230.506. Most privately offered investment pools rely on the Rule 506 exemption in their securities offerings, as the exemption is available without regard to the dollar amount of the offering. See Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 404 (proposed Jan. 4, 2007).

While Rule 506 allows issuers to include up to thirty-five unaccredited investors in offerings, the Commission recognized that in practice, “most hedge funds sell only to investors whose wealth exceeds that required to meet the standard established for accredited investor status.” SEC STAFF REPORT, *supra* note 25, at x. For additional information regarding the realities of unaccredited investors participating in hedge fund private offerings, see Jacob Preiserowicz, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 815–16 (2006). Preiserowicz notes that while funds can accept unaccredited investors, “very few do so.” *Id.* at 815. The reason for this is that such unaccredited investors likely are not investing large amounts of capital, because “otherwise they would most likely fall within the accredited class.” *Id.* As such, it is generally not cost effective for hedge funds to produce the required disclosure materials that must distributed to unaccredited investors, in light of their small investments. *Id.* at 815–16.

58. Release No. 33-6180, 19 SEC Docket 295, 298.

Certain employee plans also were included within the definition.<sup>59</sup> The SEC eschewed a broader accredited person definition until it could “monitor the use of the Rule for an appropriate period” and then “reconsider whether to enlarge the class of institutions which may be categorized as accredited persons.”<sup>60</sup>

The accredited person definition was, in fact, expanded when Congress added the accredited investor concept as part of the Small Business Investment Incentive Act of 1980.<sup>61</sup> Congress defined an individual accredited investor as “any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.”<sup>62</sup>

In 1982, the SEC adopted Regulation D to “simplify and clarify existing exemptions, to expand their availability, and . . . to facilitate capital formation consistent with the protection of investors.”<sup>63</sup> This supplanted the existing exemptions under Rules 146, 240 and 242.<sup>64</sup> Regulation D established three exemptions from the registration requirements under the 1933 Act: Rule 504 exempts offers and sales not exceeding \$1,000,000;<sup>65</sup> Rule 505 exempts offers and sales not exceeding

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59. *Id.*

60. *Id.*

61. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C. § 80 (2000)). Congress enacted the Small Business Investment Incentive Act “to enhance the ability of the SEC to assist small businesses in their efforts to compete in the capital marketplace.” Theodore Parnall, Bruce R. Kohl & Curtis W. Huff, *Private and Limited Offerings After a Decade of Experimentation: The Evolution of Regulation D*, 12 N.M. L. REV. 633, 670 (1982).

62. Small Business Investment Incentive Act § 603.

63. Securities Act Release No. 33-6389, 24 SEC Docket 1166, 1166 (Mar. 8, 1982).

64. *Id.* The Commission rescinded Rules 146, 240 and 242 on June 30, 1982. *Id.* For information on Rule 146, see *supra* notes 45–54 and accompanying text. For information on Rule 242, see *supra* notes 55–60 and accompanying text. Rule 240 was adopted by the commission on March 15, 1975 under Section 3(b) of the 1933 Act. Securities Act Release 33-5560, 6 SEC Docket 132, 132 (Jan. 24, 1975). Rule 240 provided for an issuer exemption for small business issuers, “where, because of the small size and limited character of the offering, the public benefits of registration would be too remote.” Parnall, Kohl & Huff, *supra* note 61, at 654. The rule specified that offerings to fewer than 100 beneficial owners, for less than \$100,000 for any twelve-month period, were exempt from registration requirements. 17 C.F.R. § 230.240(f) (1982). For additional information on Rule 240, see Parnall, Kohl & Huff, *supra* note 61, at 654–60.

65. Rule 504, 17 C.F.R. § 230.504 (2007). The relevant portions of Rule 504 read:

To qualify for exemption under this [Rule 504], offers and sales must satisfy the terms and conditions of [Rule 501] and [502] (a), (c) and (d) . . . [and t]he aggregate offering price for an offering of securities under this [Rule] . . . shall not exceed \$1,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this [Rule].

\$5,000,000;<sup>66</sup> and Rule 506 exempts offers and sales without regard to dollar amount.<sup>67</sup> In Rule 501, the Commission also adopted certain definitions, terms and conditions that are applicable throughout the regulation.<sup>68</sup> Included within the regulation's definitions was the term "accredited investor," which the Commission characterized as "an expansion of the term 'accredited person' in Rule 242."<sup>69</sup> Regarding natural people, the Commission adopted two accredited investor definitions: one based on net worth and one based on income.<sup>70</sup> Under the net worth test, an accredited investor is one "whose net worth at the time of purchase is \$1,000,000. Net worth may be either the individual worth of the investor or the joint net worth of the investor and the investor's spouse."<sup>71</sup> Under the income-based definition, an accredited investor is one "who has an income in excess of \$200,000 in each of the last two years and who reasonably expects an income in excess of \$200,000 in the current year."<sup>72</sup> In calculating the number of purchasers in an offering the Commission exempts accredited investors,<sup>73</sup> such that an issuer may offer

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*Id.*

66. Rule 505, 17 C.F.R. § 230.505 (2007). The relevant portions of Rule 505 read:

To qualify for exemption under the section, offers and sales must satisfy the terms and conditions of [Rule 501] and [Rule 502]. . . . The aggregate offering price for an offering of securities under this [Rule 505] . . . shall not exceed \$5,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this section . . . . There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this section.

*Id.*

67. Rule 506, 17 C.F.R. § 230.506 (2007). The relevant portions of Rule 506 read:

To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of [Rule 501] and [Rule 502]. . . . There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this section. . . . Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

*Id.* For information regarding the thirty-five unaccredited purchaser limit under Rules 505 and 506, see *supra* note 57.

68. Rules 501 through 503 set forth the definitions, terms, and conditions which are applicable to Regulation D. Release No. 33-6389, 24 SEC Docket 1166, 1167. Rule 502 sets forth the general conditions which must be met for offerings under Rules 504 through 506. Rule 502, 17 C.F.R. § 230.502 (2007). Rule 503 sets forth the filing requirements for notice of sale forms (form D), which require an indication of the exemption being claimed. Rule 503, 17 C.F.R. § 230.503 (2007).

69. Release No. 33-6389, 24 SEC Docket 1166, 1169.

70. *Id.* at 1172.

71. *Id.*

72. *Id.*

73. See Rule 501(e), 17 C.F.R. § 230.501(e) (2007).

its interests to thirty-five purchasers and an unlimited number of accredited investors.<sup>74</sup> Commentators noted that the adoption of Regulation D “brought certainty” to the private offering, because issuers could now confidently determine whether an investor was accredited and whether an offering was exempted based on objective criteria.<sup>75</sup>

In 1988, the Commission expanded the accredited investor income-based definition to include spousal joint income.<sup>76</sup> Under the expanded definition, an accredited investor was one “who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”<sup>77</sup> The following year, the Commission enacted Rule 508, which created a safe harbor for issuers from civil liability for unintentional and insignificant violations of Regulation D made in good faith.<sup>78</sup> Rule 508 dramatically reduced the risk involved in “making gambles about the subjective sophistication of investors.”<sup>79</sup>

Since the addition of the spousal joint income test and the issuer’s safe harbor under Rule 508, little has changed substantively to the accredited investor definition under Regulation D.<sup>80</sup> Currently, a natural person who is an accredited investor is one

whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000 . . . [or] who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in

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74. See Mercer Bullard, *Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen*, 13 STAN. J.L. BUS. & FIN. 286, 331 (2008).

75. See Paredes, *supra* note 23, at 997 n.91; see also Sargent, *supra* note 45, at 239 (noting that the enactment of Regulation D “represented an attempt to make the exemptive system more workable”).

76. Securities Act Release No. 33-6758, 40 SEC Docket 449, 450 (Mar. 3, 1988).

77. *Id.* at 453.

78. Securities Act Release No. 33-6825, 43 SEC Docket 704, 705–06 (Mar. 14, 1989). Rule 508 provides a safe harbor for those issuers who fail to comply with a requirement of Regulation D, so long as “the requirement is not designed to protect specifically the complaining person; the failure to comply is insignificant to the offering as a whole; and there has been a good faith and reasonable attempt to comply with all requirements of the regulation.” *Id.* at 704; see also Rule 508, 17 C.F.R. § 230.508 (2007).

79. See Friedman, *supra* note 23, at 301.

80. Securities Act Release No. 33-8766, 72 Fed. Reg. 400 (proposed Jan. 4, 2007). In 2001, the SEC proposed defining the term “qualified purchaser” under the 1933 Act to mean “accredited investor” as it is defined in Rule 501. Securities Act Release No. 33-8041, 76 SEC Docket 1035, 1035 (Dec. 19, 2001).

excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.<sup>81</sup>

## B. A Need for Change

### 1. The Evolving Financial Landscape

The tremendous growth of hedge funds necessitates the revision of the accredited investor definition. Hedge fund investment is growing, due, in part, to its fashionable reputation.<sup>82</sup> Increased participation of institutional investors in the hedge fund industry has also contributed to the area's growth.<sup>83</sup> As hedge fund investment grows, it plays an increasingly significant role in the securities markets.<sup>84</sup> In light of this growth and impact on the securities market, the Commission is concerned that there are currently not enough protections in place for hedge fund investors.<sup>85</sup>

The first hedge fund was created by Alfred Winslow Jones in 1949 as a private partnership.<sup>86</sup> Jones' private partnership was labeled a "hedge fund" because of its "hedging" investment strategy, which involved investing "in equities and us[ing] leverage and short selling to 'hedge' the portfolio's exposure to movements of the corporate equity markets."<sup>87</sup> Under such a hedging strategy, the goal is to generate returns regardless of market movement.<sup>88</sup> Early hedge funds also employed arbitrage<sup>89</sup> as an

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81. Rule 501(a), 17 C.F.R. § 230.501(a) (2007).

82. Susan Chandler, *Leader Wants Morningstar to Rise Higher in Firmament: Profile Morningstar CEO Joe Mansueto*, SEATTLE TIMES, July 30, 2006, at F1 (noting that "hedge funds have become the trendy place to invest for institutions and high-net-worth individuals."); see also Justin Lahart, *Ahead of the Tape: Hedged In*, WALL ST. J., Oct. 25, 2004, at C1 (noting that nine "years ago, members of the country-club set were bragging about the hot stock they had bought. Nowadays, it is all about having money with a hot manager. The sexy thing to say is, 'Yeah, I'm in a hedge fund'") (internal quotations omitted); see *supra* notes 25–26 and accompanying text.

83. See Press Release, Russell Investment Group, *Investing Alternatives to Surge Worldwide*, 2 (Sept. 12, 2005), available at [http://www.russell.com/no/Media\\_Centre/Press\\_Releases/Current\\_Releases/Alternative%20Survey%20Release\\_UK.pdf](http://www.russell.com/no/Media_Centre/Press_Releases/Current_Releases/Alternative%20Survey%20Release_UK.pdf); see also Thierry Olivier Desmet, *Understanding Hedge Fund Advisor Regulation*, 4 HASTINGS BUS. L.J. 1, 9 (2008) (noting that the Virginia Retirement System has \$1.6 billion invested in hedge funds, and the California Public Employees' Retirement System has \$2 billion invested in hedge funds).

84. See *infra* notes 100–01 and accompanying text.

85. See *infra* notes 104–05 and accompanying text.

86. SEC STAFF REPORT, *supra* note 25, at 3.

87. *Id.* "Hedging" is an investment strategy, which takes "long and short positions in debt and equity securities as a means of offsetting some of the investment risks associated with market uncertainties." Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 684 (2000).

88. See Desmet, *supra* note 83, at 3. The goal of hedging is in contrast with the investment goal inherent in buying stock, which is "the more limited goal of outperforming other investors or market

investment strategy. Today, hedge funds are not merely involved in hedging or arbitrage.<sup>90</sup> Rather, hedge funds engage in a diverse range of investment strategies, such as trading equities, fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, future contracts, commodity options and other non-securities investments.<sup>91</sup>

Generally, hedge funds hold a pool of securities or assets that are not registered under any of the securities laws.<sup>92</sup> Hedge funds may use the Regulation D private offering exemptions to avoid registration requirements by only issuing their interests to accredited investors.<sup>93</sup> Under Regulation D's Rule 506, issuers may offer interests to as many as thirty-five unaccredited investors, so long as those purchasers are sophisticated.<sup>94</sup> But in practice, hedge funds rarely issue securities to unaccredited investors, because doing so is not cost efficient.<sup>95</sup>

Hedge funds typically employ a fee structure which compensates the hedge fund advisors based on the fund's capital gains and capital appreciation.<sup>96</sup> Fund advisors generally receive an annual management fee of 1–2% of assets under management plus a 20% share of the fund's annual appreciation.<sup>97</sup> Capital raised by hedge funds generally includes significant investments by the fund's own advisory personnel.<sup>98</sup>

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indices." *Id.*

89. SEC STAFF REPORT, *supra* note 25, at 3–4. Similar to hedging, arbitrage is an investment strategy employed by hedge funds. Arbitrage involves buying and selling the same security in different markets to exploit and profit from the security's pricing differences. Matthew Goldstein, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. INT'L BUS. & L. 111, 116 (2007).

90. SEC STAFF REPORT, *supra* note 25, at 3–4.

91. *Id.* at 3.

92. *Id.* at viii.

93. *Id.* at x. In addition to the private offering exemption under Regulation D, hedge funds may also rely on the sophisticated investor exclusion under the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified at 15 U.S.C. §§ 80a-1 to 80a-64 (2000)). *Id.* Under this exclusion, the private investment vehicle may only sell interests to "qualified purchasers." A qualified purchaser, who is a natural investor, is one who owns "not less than \$ 5,000,000 in investments." 15 U.S.C. § 80a-2(a)(51).

94. Rule 505, 17 C.F.R. § 230.505 (2007); Rule 506, 17 C.F.R. § 230.506 (2007).

95. See SEC STAFF REPORT, *supra* note 25, at x; see also Preiserowicz, *supra* note 57, at 815–16. For a summary of the disclosure requirements for hedge funds issuing securities to unaccredited investors, see *infra* note 111.

96. SEC STAFF REPORT, *supra* note 25, at viii.

97. *Id.* at ix. This fee structure is often known as the "Two and Twenty," as receipt of 2% of the assets under management plus 20% of the fund's profits is generally the most common management fee arrangement. See Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833, 838 (2008).

98. SEC STAFF REPORT, *supra* note 25, at viii.

Today, hedge funds continue to grow at a rate significantly higher than other financial sectors.<sup>99</sup> Hedge funds play an important role in securities markets as repeat traders of securities, which increases market efficiency<sup>100</sup> and enhances liquidity.<sup>101</sup> Hedge funds also impact the securities market through their extensive use of leverage.<sup>102</sup> The continued growth of hedge funds is of interest due to the potential impact it may have on the character of financial markets.<sup>103</sup>

Dramatic hedge fund growth has led to concerns about current levels of protection for hedge fund investors.<sup>104</sup> The popularity, growth, and prevalence of hedge funds means that more and more people are investing in them, and as this population of investors grows larger, it is more likely to include hapless individuals who do not have the sophistication necessary to fend for themselves.<sup>105</sup> Further, commentators have noted that as the hedge fund industry continues to grow, there is greater potential for hedge funds to fail as a result of excessive use of leverage combined with

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99. *Id.* at 1. The Commission noted that hedge fund assets grew 1084% from 1993 to 2003, while mutual fund assets grew 289% during the same period. *Id.* at 1 n.4. *See also supra* notes 25–26 (detailing additional measures of recent hedge fund growth).

100. *See Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management: Hearing Before the H. Comm. on Banking and Financial Services*, 105th Cong. 151 (1998) (statement of Alan Greenspan, Former Chairman, Board of Governors of the Federal Reserve), available at <http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/1998/19981001.htm>.

[Hedge funds] contribute to market efficiency in two ways: First, the identification of arbitrage opportunities requires extensive research. By executing trading strategies based on their market research, hedge funds improve the informational efficiency of markets by embedding that information into market prices. Second, whether hedge fund trades reflect an arbitrage strategy or speculation, their active presence in the market improves liquidity. Given that hedge funds often bet against the direction of the market, they provide ready counterparties in trades and thus help to complete the market.

WILLIAM P. OSTERBERG & JAMES B. THOMSON, *THE TRUTH ABOUT HEDGE FUNDS* 4 (1999), available at <http://www.clevelandfed.org/research/Commentary/1999/0501.pdf>. *See also* Oppold, *supra* note 97, at 840 (noting that “[i]n 2006, one estimate claimed that hedge funds accounted for up to 50% of daily trading volume in some asset classes.”).

101. SEC STAFF REPORT, *supra* note 25, at 4. Liquidity is an economics term which “refers to the willingness of participants to enter the market and buy or sell. The more buyers and sellers willing to enter the market, the more liquid it is.” GORDON DE BROUWER, *HEDGE FUNDS IN EMERGING MARKETS* 22 (2002). *See also* OSTERBERG & THOMSON, *supra* note 100, at 3 (regarding the impact of hedge fund trading on market liquidity).

102. *See* Oppold, *supra* note 97, at 839. Oppold notes that a \$5 billion hedge fund with a debt-to-equity ratio of 25:1 has an estimated \$125 billion impact on the capital markets. *Id.*

103. SEC STAFF REPORT, *supra* note 25, at 2.

104. Securities Act Release No. 33-8766, 72 Fed. Reg. 400 (proposed Jan. 4, 2007); Securities Act Release No. 33-8828, 72 Fed. Reg. 45116, 45126 (proposed Aug. 10, 2007).

105. *See* Franklin R. Edwards, *Hedge Fund and Investor Protection Regulation*, *ECON. REV.*, Fourth Quarter, 2006, at 35, 43 (noting that “more unsophisticated investors are able to participate in hedge fund investments than in prior years and that this participation may have contributed to the growing fraud problem that the SEC has observed.”).

high concentrations of capital, conflicts of interest, or fraud.<sup>106</sup> These concerns are part of what has motivated the Commission to consider increasing its regulatory requirements for private offering purchasers via revisions to the accredited investor definition.<sup>107</sup>

## 2. Criticisms of the Accredited Investor Definition

In establishing Regulation D, the SEC's goal was to provide a clear and objective standard to determine whether a purchaser has "sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can."<sup>108</sup> In striving to achieve this goal, the Commission has relied upon wealth as a proxy for a determination that an investor is capable of fending for him or herself.<sup>109</sup> Regulation D was initially welcomed when it was adopted in 1982, but as issuers and purchasers gained more experience in dealing with the regulation, criticism mounted,<sup>110</sup> especially towards the Commission's wealth-based proxy.<sup>111</sup>

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106. See Desmet, *supra* note 83, at 10–13.

107. Release No. 33-8766, 72 Fed. Reg. 400; Release No. 33-8828, 72 Fed. Reg. 45126. As of 2004, "the Commission [had] brought 46 enforcement cases asserting that hedge fund investors [had] been defrauded of an estimated \$1 billion by their advisers." Cynthia M. Fornelli, SEC Deputy Dir., Remarks Before the Hedge Fund Best Practices Seminar: Succeeding in the New Regulatory Environment (Sept. 14, 2004), available at <http://www.sec.gov/news/speech/spch091404cmf.htm>.

108. Release No. 33-8766, 72 Fed. Reg. 400, 405. For background information on the history of Regulation D, see *supra* notes 27–81.

109. See Paredes, *supra* note 23, at 997; see also Fletcher, *supra* note 23, at 1124 (noting that the Commission has prioritized wealth over sophistication as the essential measure of accredited investor status).

110. See Sargent, *supra* note 45, at 240–41.

111. Legal scholars have been critical of the Commission's wealth-based accredited investor standard. See, e.g., Paredes, *supra* note 23; Choi, *supra* note 23; Fletcher, *supra* note 23; Friedman, *supra* note 23; Warren, *supra* note 23. Commentators and investors also have been critical. See, e.g., Comment Letter from David Patch (Apr. 13, 2007), available at <http://sec.gov/comments/s7-25-06/s72506-613.pdf> (the accredited investor minimum net income requirements restrict "sophisticated individuals from investing in a hedge fund and yet a wealthy yet uneducated individual can be accepted"); Comment Letter from Bruce A. Broussely (Apr. 10, 2007), available at <http://www.sec.gov/comments/s7-25-06/s72506-612.htm> ("By having ANY minimum net worth requirement, you have in effect told millions of college-educated people with degrees in finance (including myself), engineers, CPAs and other professionals that they are not smart enough to invest, which is the height of elitism."); see also Nathan J. Greene, *The SEC's Latest Hedge Fund Rulemaking: More than 600 Comment Letters Later*, BANKING & FIN. SERVICES POL'Y REP., July 2007, at 1, 4. Legal scholars and commentators have been critical of other aspects of Regulation D, such as Rule 502's disclosure requirements, and the Form D notice requirements. See Sargent, *supra* note 45, at 240–41. Under Rule 502(b), when an issuer sells a security to an unaccredited investor, the issuer must furnish financial statement information prior to the sale of securities. Rule 502, 17 C.F.R. § 230.502 (2007). For a summary of Rule 502's disclosure requirements, see Terrence A. Everett, *Private Placements Under*



Several flaws exist with a wealth-based proxy for sophistication and invulnerability. First, net worth may not, in fact, be an indication of an investor's sophistication or of an investor's ability to bear the risk of loss.<sup>112</sup> For example, it is possible that an investor who is accredited on the basis of income "may actually be insolvent at the time of purchase."<sup>113</sup> Also, just because an investor is accredited does not guarantee that he or she will be capable of avoiding opportunistic brokers or get-rich-quick schemes.<sup>114</sup>

Second, the accredited investor definition is "both under- and overinclusive" in scope.<sup>115</sup> It is underinclusive because otherwise financially knowledgeable investors may be deemed unaccredited because they do not meet the minimum wealth requirements.<sup>116</sup> Conversely, the accredited investor definition is overinclusive because a financial novice may be deemed accredited, as long as he or she meets the standard's requirements based upon the accident of being rich.<sup>117</sup> Indeed, the Commission itself has recognized that the current accredited investor definition may be overinclusive.<sup>118</sup> The SEC noted that due to inflation and sustained growth in wealth, many more individuals now meet the wealth and income thresholds than when the standards were initially set.<sup>119</sup> Such inflation and sustained growth in wealth results in more accredited investors, many of whom may not be able to appreciate the risks of investing in private offerings.<sup>120</sup>

Third, the motivation for enacting the accredited investor definition in Regulation D—to clarify the private offering exemptions and the risk of liability for noncompliance<sup>121</sup>—is no longer relevant due to the enactment

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*United States Federal Securities Law*, 9 U.S.-MEX. L.J. 157, 165–67 (2001). Under Rule 503, an issuer offering or selling securities under the private offering exemption must file five copies of Form D with the Commission. Rule 503, 17 C.F.R. § 230.503 (2007). Form D requires basic issuer identification data and information about the offering, the offering price, the number of investors, expenses, and use of proceeds. Form D is available through the Commission's website at <http://www.sec.gov/about/forms/formd.pdf> (last visited Dec. 22, 2008).

112. *See* Warren, *supra* note 23, at 382.

113. *Id.*

114. *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 19 (2003).

115. Choi, *supra* note 23, at 310.

116. *Id.* at 311.

117. *Id.*

118. Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 404 (proposed Jan. 4, 2007).

119. *Id.*

120. *Id.* The Commission noted that accredited investors may not be able to appreciate the risks specific to private offerings, such as "undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns." *Id.*

121. Securities Act Release No. 33-6389, 24 SEC Docket 1166, 1166 (Mar. 8, 1982).

of Rule 508.<sup>122</sup> Rule 508 creates a safe harbor, stating that “failure to comply with [Rules 504, 505, or 506] will not result in the loss of exemption [privileges, so long as] . . . [t]he failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity[,] . . . that was insignificant with respect to the offering as a whole[,]” and was in good faith.<sup>123</sup> With the enactment of Rule 508, issuers no longer need to worry about inadvertently issuing securities to an unaccredited investor and losing their private offering exemptions.<sup>124</sup> As such, the enactment of Rule 508 minimizes the need for an objective wealth-based accredited investor standard, because it removes the risk associated with making subjective determinations of accreditation.<sup>125</sup>

### C. *Alternative Proposals*

#### 1. *Investor Classification*

Legal scholars have recognized the flaws in the current accredited investor definition and have proposed possible alternatives. Scholars advocating a move away from the current wealth-based accredited investor definition typically emphasize the importance of investors’ knowledge of the financial marketplace.<sup>126</sup> But, scholars disagree about whether investor knowledge alone is a sufficient indicator of sophistication.<sup>127</sup> For instance, within Stephen Choi’s information-based classification system, investor knowledge and accessibility to informational resources are determinative of an investor’s classification group and the corresponding transactions available to that group.<sup>128</sup> Choi suggests classifying investors into four groups based upon their relative knowledge and resources: (1) issuer-level investors,<sup>129</sup> (2) intermediary-level investors,<sup>130</sup> (3) aggregate-level

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122. See Friedman, *supra* note 23, at 301.

123. Rule 508, 17 C.F.R. 230.508 (2007).

124. See Friedman, *supra* note 23, at 301.

125. See *id.*

126. See Choi, *supra* note 23; Fletcher, *supra* note 23. Choi’s information-based classification scheme deals with investors generally, rather than those investors involved in private offerings, but is still applicable as an investor classification scheme for those investors involved in private offerings. See Choi, *supra* note 23, at 280.

127. See Choi, *supra* note 23; see Fletcher, *supra* note 23.

128. See Choi, *supra* note 23, at 285–301.

129. Choi’s first classification group, “issuer-level investors,” are those investors “who are informed about issuer-specific risks and the various types of investor protections that issuers may adopt.” *Id.* at 285. Within Choi’s classification scheme, the transactions which issuer level investors may engage in are not limited in any fashion. *Id.*

investors,<sup>131</sup> and (4) unsophisticated investors.<sup>132</sup>

In contrast, C. Edward Fletcher III's investor classification scheme eschews a knowledge-determinative classification system like Choi's in favor of a broader multi-factored sophistication inquiry.<sup>133</sup> Fletcher's determination of investor sophistication proceeds by examining three categories of investor-specific information: (1) an investor's financial and business acumen, (2) individual characteristics of sophistication, and (3) investment-specific behavior.<sup>134</sup> For Fletcher, knowledge is merely one of several relevant factors in the sophistication inquiry.<sup>135</sup>

If the SEC were to consider Choi's and Fletcher's alternative investor classification schemes, it would likely find Fletcher's multi-factored approach more attractive than Choi's knowledge-determinative approach. Fletcher's proposed factors are culled from existing judicial opinions distinguishing between sophisticated and unsophisticated investors.<sup>136</sup> In

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130. Intermediary-level investors are investors who do not have issuer-level information, nor do they have "a direct market incentive to adopt value-maximizing investor protections." *Id.* at 290. Choi posits that intermediary-level investors should be required to "associate with a securities market intermediary for all of their transactions." *Id.* at 291.

131. Aggregate-level investors are those investors who have "the capacity to track highly visible organizations" (HVOs), but do not have the resources or incentives to research issuers or intermediaries, and as such, find it cost-effective "to inform themselves on the reputation and provided investor protections of certain [HVOs]." *Id.* at 296. Under Choi's classification scheme, aggregate-level investors will be required to associate themselves with "an HVO or an HVO-sanctioned market participant for all of their securities transactions." *Id.* at 298.

132. Unsophisticated investors are those investors who "lack either the rationality or the capacity to investigate and accurately value protections provided at even the aggregate level." *Id.* at 300. Unsophisticated investors would only be able to deal with HVOs or HVO-sanctioned market participants, and regarding only passive-index mutual funds. *Id.* at 300-01.

133. See Fletcher, *supra* note 23, at 1149-53.

134. *Id.* Within these three categories are several subcategories. Under financial and business acumen, which Fletcher deems "the most important single criterion of investor sophistication," are "investment experience," "professional status," "history of speculative investments," "government or business experience," "professional experience in the securities industry," and "general familiarity with securities transactions." *Id.* at 1149-50. Under individual characteristics of sophistication are "understanding trading in an investment account," "education," "special access to information," "intelligence," "age," and "wealth and income." *Id.* at 1150-52. Under investment-specific behavior are "regular consultation with investment professionals," "number of brokerage accounts," "stock club membership," "amount of money invested," "scrutiny over investment accounts," "attending investing conferences," "subscribing to financial or investment journals," and "viewing financial television programming." *Id.* at 1152-53.

135. *Id.* at 1149-53.

136. For example, Fletcher bases his use of "professional status" as a subcategory of "financial and business acumen" upon the following judicial decisions: *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073, 1093-96 (4th Cir. 1979); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 1385 (W.D. Va. 1986), *aff'd*, 840 F.2d 236 (4th Cir. 1988); *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F. Supp. 471, 481-82 (D. Me. 1986); *Smith v. Sade & Co.*, No. 81-2628, 1982 WL 1341 (D.D.C. Oct. 27, 1982); *Scarfariotti v. Bache & Co., Inc.*, 438 F. Supp. 199, 204 (D.C.N.Y. 1977). See Fletcher, *supra* note 23, at 1149 n.389.

contrast, Choi's approach is a postulate influenced by the current restrictive nature of the federal securities regime, rather than a study of existing judicial opinions.<sup>137</sup> Moreover, one of Fletcher's factors ("amount of money invested") was incorporated into the Commission's proposed revisions to the accredited investor definition, further evidencing likelihood that the Commission would favor his scheme.<sup>138</sup>

## 2. *Licensing/Regulatory Regimes*

The current federal securities regulatory regime was enacted to protect investors by providing disclosure and protecting against fraud.<sup>139</sup> This is achieved through the regulation of issuers, intermediaries and self-regulatory organizations.<sup>140</sup> However, legal scholars advocating a change to the current accredited investor definition also stress the importance of refocusing the current regulatory regime.<sup>141</sup> For example, Stephen Choi posits that the emphasis of federal securities regulation should be on regulating investors directly.<sup>142</sup> In keeping with Choi's knowledge-based investor classification scheme,<sup>143</sup> appropriate investor regulation would depend upon an individual investor's particular knowledge base.<sup>144</sup> Choi suggests that issuer-level investors, his most knowledgeable and sophisticated class of investors, should not be subject to mandatory regulation.<sup>145</sup> Choi's next most knowledgeable and sophisticated class of

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137. See Choi, *supra* note 23, at 280–81.

138. Fletcher includes "amount of money invested" as one of sophistication inquiry factors, noting that "[s]ome investors put hundreds of thousands or even millions of dollars at risk in securities investments; such investments show sophistication." Fletcher, *supra* note 23, at 1152. The proposed revision to the accredited investor definition would add a requirement that natural persons not only meet the current accredited investor definition (have a net worth that exceeds \$1,000,000, or have an individual income in excess of \$200,000 or jointly with his or her spouse in excess of \$300,000), but own not less than \$2,500,000 in investments at the time of purchase of securities. See Rule 501(a), 17 C.F.R. § 230.501(a) (2007); Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 405 (proposed Jan. 4, 2007). The Commission notes that this is to ensure that investors are "capable of evaluating and bearing the risks of their investments." *Id.* at 400.

139. See Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a to 77bbbb (2000)).

140. See Choi, *supra* note 23, at 280.

141. *Id.*; Friedman, *supra* note 23.

142. See Choi, *supra* note 23, at 280.

143. See *supra* notes 129–32.

144. See Choi, *supra* note 23, at 280.

145. Within Choi's investor regulation system, when issuers transact with issuer-level investors, issuers would "internalize both the cost and benefit of investor protections." *Id.* at 285. In addition, issuers transacting with issuer-level investors would not be subject to mandatory regulation, mandatory information disclosure or antifraud liability. *Id.* Correspondingly, issuer-level investors selling their interests to other issuer-level investors would not be subject to mandatory regulation. *Id.* Under such a self-tailored regulatory system, issuers transacting with issuer-level investors would be able to

investor, intermediary-level investors, would also avoid mandatory regulation, so long as they associated themselves with appropriate intermediaries.<sup>146</sup> Choi's aggregate-level investors would, however, be subject to mandatory regulation. Aggregate-level investors would be required to associate themselves with highly visible organizations ("HVOs") or HVO-sanctioned market participants.<sup>147</sup> Finally, Choi's least knowledgeable and least sophisticated class of investors, unsophisticated investors, would be required to associate themselves with HVOs or HVO-sanctioned market participants, similar to aggregate level investors, but with the additional restriction that they transact only in passive-index mutual funds.<sup>148</sup>

To implement his system of investor classification and investor self-regulation, Choi proposes a licensing system, wherein investors would have to obtain a license prior to engaging in any securities transactions.<sup>149</sup> Choi considers three options: a mandatory licensing system, a voluntary licensing system, or a hybrid system incorporating aspects of both the mandatory and voluntary systems.<sup>150</sup> Under Choi's mandatory licensing scheme, investors' acumen would be tested according to their knowledge

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determine the standard of liability that they would face, e.g., strict liability or criminal liability. *Id.* at 286–87. Additionally, within this self-tailored regulatory scheme, issuers may also “select the level of enforcement they will face.” *Id.* at 287. Self-tailored regulation would govern both primary and secondary market transactions. *Id.*

146. With intermediary-level investors, there is still not a need for mandatory regulation; rather, “so long as issuers deal with investors associated with appropriate intermediaries, the intermediaries will act for the investors in screening investments and in negotiating with issuers for value-maximizing protections.” *Id.* at 290. For this classification of investor, Choi posits that intermediary-level investors should be required to “associate with a securities market intermediary for all of their transactions.” *Id.* at 291. Choi proposes circumventing prohibitive costs associated with applying investor protections, as well as problems associated with intermediaries cheating on a high reputation, with self-tailored regulation aimed at intermediaries. *Id.* at 293. Much like the self-tailored regulatory scheme for issuers, here, intermediaries “could bind themselves to particular screening procedures, conflict of interest prohibitions, minimum capitalization requirements, and other devices at a lower cost than through contract or reputation.” *Id.* This may reduce the investor-related costs of researching the reputation of specific intermediaries. *Id.* at 294.

147. Under Choi's classification scheme, aggregate-level investors will be required to associate themselves with “an HVO or an HVO-sanctioned market participant for all of their securities transactions.” *Id.* at 298. Much like issuers and intermediaries, HVOs would also take part in self-tailored regulation. *Id.* at 300. This would allow HVOs “to design value-maximizing investor protections across all levels of market participants.” *Id.*

148. Under Choi's classification scheme, unsophisticated investors are those investors who “lack either the rationality or the capacity to investigate and accurately value protections provided at even the aggregate level.” *Id.* Unsophisticated investors would only be able to deal with HVOs or HVO-sanctioned market participants, and regarding only passive-index mutual funds. *Id.* at 300–01.

149. *Id.* at 310–19.

150. *Id.*

of market participants, market risks, and available investor protections.<sup>151</sup> As an alternative to mandatory licensing, Choi also proposes a voluntary licensing scheme whereby investors can “self-select into appropriate regulatory categories.”<sup>152</sup> As a final alternative, Choi proposes a hybrid of his mandatory and voluntary licensing schemes, which would include a voluntary licensing regime with certain mandatory aspects.<sup>153</sup>

In contrast to Choi, who advocates abolishing the current securities regulatory regime,<sup>154</sup> Howard M. Friedman asserts that the Commission should supplement the current regulatory framework with an increased emphasis on broker-dealer regulation.<sup>155</sup> For Friedman, the current regulatory framework does not accord enough weight to portfolio diversification.<sup>156</sup> He suggests that appropriate broker-dealer regulation can be achieved by following the New Jersey Superior Court’s test in *Ehrlich v. First National Bank of Princeton*.<sup>157</sup> The *Ehrlich* court held that when a professional is engaged not just as a broker to execute stock transactions, but as an investment advisor, prudent advice includes “(1) knowing the customer, his assets and objectives; (2) diversifying investments; (3) engaging in objective analysis as the basis for purchase

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151. *Id.* at 311.

152. *Id.* at 313. Under Choi’s voluntary licensing scheme, “investors who understand their own information capacity,” will be able to determine their appropriate regulatory category. *Id.* To illustrate this, Choi provides the following example:

[C]onsider Andrew, an unsophisticated investor. Under a voluntary licensing scheme, if Andrew opts into the category of issuer-level investors, he will purchase securities of issuers that focus their efforts and investor protections on issuer-level investors. Consequently, no investor protection will exist to protect the unsophisticated in the issuer-level market segment; issuer-level investors will refuse to pay for these protections. Andrew will therefore be at a greater risk of fraud among other risks and will systematically do worse than more sophisticated investors in the market. To the extent Andrew is rational and understands his own capabilities, he will therefore choose not to license himself as an issuer-level investor.

*Id.* at 314.

153. *Id.* at 318–19. For Choi, there is no specific combination of the mandatory and voluntary licensing schemes that will produce the perfect blend of the two. One possibility is a voluntary licensing regime with certain mandatory aspects such as a mandatory “waiting period for investors to move from aggregate-level to intermediary-level and eventually to issuer-level. . . . Alternatively, regulators could employ a mandatory licensing regime that gives investors some confined ability to select their proper license level.” *Id.*

154. *Id.* at 283 (advocating that regulators abolish “most of the Securities Act and the Exchange Act, as well as much of the Investment Advisors Act of 1940”).

155. See Friedman, *supra* note 23, at 301.

156. To achieve more meaningful protection for individual accredited investors in private offerings, Friedman posits that there must be assurance in the securities regulatory framework that “securities will be sold at appropriate prices and will be placed only in diversified portfolios, or only in the undiversified portfolios of those who clearly understand the ramifications of nondiversification.” *Id.*

157. *Ehrlich v. First Nat’l Bank of Princeton*, 505 A.2d 220 (N.J. Super. Ct. Law. Div. 1984).

and sale recommendations and (4) making the account productive.”<sup>158</sup> Friedman maintains that the *Ehrlich* court’s holding should prompt the Commission to require that broker-dealers “analyze the suitability of adding the particular security to the [investor’s] portfolio” and only permit sales “to those . . . investors for whom the security is suitable in light of the investor’s entire portfolio.”<sup>159</sup>

### III. ANALYSIS

#### A. *The Current Accredited Investor Definition Must be Changed*

The current accredited investor definition is faulty and incomplete; income and net worth alone are not the best measures of financial sophistication. The Commission created the accredited investor definition in hopes of creating an objective measure to determine whether an investor was eligible to participate in a private offering.<sup>160</sup> But, as scholars have noted, this bright-line standard is both under- and overinclusive.<sup>161</sup> That the definition is underinclusive is demonstrated by the introductory hypothetical case of a recent business school graduate: saddled with enormous student loan debt, she would likely not meet the minimum accredited investment wealth requirements, even though she would be financially sophisticated and able to capably assess the merits of an investment in a private offering. Conversely, the overinclusive nature of the definition would be exemplified by a high school drop-out, with no business or investment knowledge who recently won the state lottery’s \$50 million dollar jackpot. She would be deemed an accredited investor, but likely would not be financially sophisticated.

Regulation D was enacted to “simplify and clarify [the] existing exemptions,”<sup>162</sup> which had proven problematic, especially for small offerors who were unable to determine when the exemptions applied.<sup>163</sup>

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158. *Id.* at 235. The court acknowledged that this duty is a continuing one. *Id.* at 235–36.

159. See Friedman, *supra* note 23, at 316–17. States should also consider imposing an obligation on dealers licensed in their state to make annual reviews of the suitability of their clients’ portfolios. *Id.*

160. Securities Act Release No. 33-5487, 4 SEC Docket 154, 154–55 (Apr. 23, 1974); Securities Act Release No. 33-6180, 19 SEC Docket 295, 297 (Jan. 17, 1980); see Paredes, *supra* note 23, at 997 n.91; see also Sargent, *supra* note 45, at 239 (noting that the enactment of Regulation D “represented an attempt to make the exemptive system more workable”).

161. Choi, *supra* note 23, at 310.

162. Securities Act Release No. 33-6389, 24 SEC Docket 1166, 1166 (Mar. 8, 1982).

163. Securities Act Release No. 33-6121, 18 SEC Docket 287, 288 (Sept. 11, 1979); see also Alberg & Lybecker, *supra* note 38, at 635 (foreseeing some of the potential problems for issuers, especially small issuers, under Rule 146).

Issuers risked losing their exemptions if they mistakenly determined that an investor was accredited.<sup>164</sup> As scholars have noted, this rationale for employing an objective test is no longer relevant due to the enactment of Rule 508, the seller's safe harbor.<sup>165</sup> An issuer may not lose his exemption for mistakenly making an issuance to an unaccredited investor so long as that mistake was "insignificant with respect to the offering as a whole" and in good faith.<sup>166</sup> Therefore, the one-time imperative for an objective bright-line standard, such as net worth or income to determine accredited investor status, no longer exists. The absence of this animating cause, along with the inherent imperfections in the definition's scope, demonstrates that the SEC's accredited investor definition is ripe for reconsideration.

*1. Shortcomings of Existing Alternative Proposals*

*a. Shortcomings of Alternative Investor Classification Schemes*

While the current accredited investor definition is faulty and incomplete, the scholarly alternatives that have been advanced are also imperfect. For example, one of Choi's motivations for proposing an alternative classification scheme is that the current federal securities regulations are too restrictive, but Choi's classification system may still subject investors to unwarranted and unwanted restrictions.<sup>167</sup> Under Choi's proposal, unsophisticated investors are barred from transacting in anything other than passive-index mutual funds.<sup>168</sup> While this would afford protection to many vulnerable participants, it may be undesirable because it could cause unsophisticated investors to do "systematically worse than other investors."<sup>169</sup>

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164. See Friedman, *supra* note 23, at 301.

165. Rule 508, 17 C.F.R. § 230.508 (2007).

166. *Id.*

167. See Choi, *supra* note 23, at 280–81. Choi cites the 1933 Act's private offering exemption and accredited investor requirement to describe the restrictive nature of the current federal securities regime:

[T]he Securities Act of 1933 . . . forces issuers conducting a public offering to refrain from making offers of securities until they file a registration statement with the SEC and to delay sales until the registration statement becomes effective. As a result, investors are unable to purchase securities of companies choosing not to engage in a public offering unless the investors qualify to participate in a far more restrictive private placement of securities.

*Id.* at 281.

168. *Id.* at 301.

169. *Id.*



In addition, the informational resources needed to support such a scheme may not be trustworthy.<sup>170</sup> For example, Choi's intermediary-level investors must associate themselves with appropriate intermediaries, but these investors are forced to assume the risk that these intermediaries will be unfaithful or negligent in their screening duties or make unwise decisions.<sup>171</sup>

Alternatively, Fletcher's sophistication inquiry is troubling to the extent that some of his factors are thinly veiled references to wealth-based proxies; if adopted by the Commission, these factors may serve to further cement the current accredited investor standard that these legal scholars criticize.<sup>172</sup> For example, Fletcher posits that professional status is indicative of sophistication.<sup>173</sup> But Fletcher acknowledges that "professional status alone does not reveal very much; rather, it signals an investor's education and *income level*."<sup>174</sup> Thus, while Fletcher urges a move away from the current accredited investor definition, his sophistication inquiry criteria actually seem to closely track the status quo.

Additionally, some of Fletcher's factors are problematic because it may not be reasonable or realistic for the Commission or issuers to measure or gauge these factors. Fletcher contends that "scrutiny over investment accounts," "subscribing to financial or investment journals," "viewing financial television programming," and "reviewing confirmation slips or monthly statements" should all be included as subcategories of investment-specific behavior.<sup>175</sup> While these behaviors would tend to indicate investor sophistication, there is not a reasonable way for the Commission or issuers to measure such behavior beyond a purchaser honor system, which would be vulnerable to fraud.

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170. *Id.* at 290.

171. *Id.* at 295–96.

172. *See* Fletcher, *supra* note 23, at 1149–53. Additionally, Fletcher includes wealth and income as a subcategory of individual characteristics of sophistication, recognizing that "courts have suggested that high income levels or wealth indicate sophistication." *Id.* at 1151. But for Fletcher, wealth and income are not necessarily determinative of sophistication alone. In fact, Fletcher recognizes that "[a]lthough courts should consider an investor's ability to bear economic risk, they should also be sensitive to the fact that rich investors can do stupid things." *Id.* at 1152. It is possible that this is the reason that no single factor within Fletcher's sophistication inquiry is determinative of sophistication, but rather an investor's classification should be determined from a "review [of] the criteria as a whole." *Id.* at 1149.

173. *Id.* at 1149. "Doctors, lawyers, dentists, and other professionals are more sophisticated than nonprofessionals." *Id.*

174. *Id.* at 1150 (emphasis added).

175. *Id.* at 1152–53.

Fletcher also provides no guidance as to how his factors should be implemented.<sup>176</sup> For example, Fletcher asserts that “reviewing confirmation slips or monthly statements” is an indication of sophistication.<sup>177</sup> But Fletcher does not explain how the Commission should implement this factor. Should the Commission require an investor to keep a log of how many confirmation slips or monthly statements he or she reviews? Should the Commission preference some post-trade confirmation slips over others? Fletcher does not answer these questions, or any other implementation questions, and thus leaves the Commission without guidance regarding how to employ his factors.

*b. Shortcomings of Alternative Regulatory Regimes and Licensing Schemes*

Neither regulatory alternative proposed by Choi or Friedman has been adopted and incorporated into the current regulatory regime by the Commission, nor do the alternative proposals appear to have even been considered by the Commission. This may be because there are inherent flaws in Choi’s investor self-regulation system and Friedman’s supplemental broker-dealer regulation. For example, within Choi’s self-tailored regulatory regime, it is possible that such regulations may not, in fact, protect investors from dishonest or manipulative issuers.<sup>178</sup> Issuers might abuse the self-tailored regulatory system by opting to forego liability in an effort to defraud investors.<sup>179</sup> Under Choi’s self-regulatory regime, it is also possible that “managers of issuers may face a conflict in determining an issuer’s self-tailored regulation provisions.”<sup>180</sup> Additionally, issuers may implement protections to encourage issuer-level investors to pay a higher price for interests, only to remove the protections after the offering is completed.<sup>181</sup> Finally, there is a concern that the self-

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176. *See id.* at 1149–53.

177. *Id.* at 1153.

178. *See Choi, supra* note 23, at 288–89.

179. *Id.* at 288. For example, within Choi’s system, “issuers dealing with issuer-level investors could opt out completely from public regulation.” *Id.* at 286. The flaw inherent in Choi’s self-tailored regulation is that issuers can opt out of public regulation, planning to defraud their investors, knowing that they are not subject to regulatory liability. *See id.* at 287–88.

180. *Id.* at 288. Choi reasons that, although “criminal liability may provide issuers a low-cost means of signaling credibility to the market that the company will disclose truthfully . . . because managers [would] face the possibility of incarceration under criminal liability, they may choose not to incorporate such provisions into the issuer’s self-tailored regulation.” *Id.*

181. *Id.* at 289. For example, “[m]anagement might implement shareholder devices such as proxy contest rules and takeover-friendly rules when issuing securities in order to obtain a high price for their shares, but then remove these protections once the offering is completed.” *Id.*

tailored regulatory scheme will “result in too many private regulators.”<sup>182</sup> Likewise, Friedman’s increased emphasis on broker-dealer regulation does not provide protection for investors who opt not to utilize broker-dealers or similar intermediaries.<sup>183</sup>

Choi’s proposal to scrap the existing federal securities regulatory regime is far too sweeping in scope. Under Choi’s self-regulatory regime, regulators would abolish the existing federal securities framework.<sup>184</sup> Such a drastic measure would eliminate useful regulatory rules like Rule 10b-5 promulgated under the 1934 Act,<sup>185</sup> which has been called the “most important legal protection for holders of securities against fraud, deception, insider trading, and corporate malfeasance.”<sup>186</sup>

Choi’s proposed mandatory and voluntary licensing schemes are also flawed.<sup>187</sup> A mandatory licensing system adds complexity and potential administrative burdens to the existing regulatory framework.<sup>188</sup> Choi notes that to implement such a licensing test, the SEC would have to design an appropriate exam and exam materials.<sup>189</sup> Additionally, there is the possibility of error: “[W]ell-informed investors might fail to receive a higher level of licensing despite their qualifications,” and “[c]onversely, some less-informed investors might mistakenly receive licensing at a higher level than their abilities warrant.”<sup>190</sup> One final flaw in Choi’s voluntary licensing scheme is that investors may not be able to appropriately gauge their own level of investment knowledge due to overconfidence or loss-averse personality types.<sup>191</sup>

#### IV. PROPOSAL

The current accredited investor definition for natural persons is ripe for a fresh and reconsidered approach for at least four reasons. First, the current accredited investor definition is flawed and has been heavily

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182. *Id.*

183. *See* Friedman, *supra* note 23, at 316.

184. *See* Choi, *supra* note 23, at 283.

185. 17 C.F.R. § 240.10b-5 (2007). Rule 10b-5 allows “private holders of securities [to] bring actions against those who have used fraud or misrepresentation in connection with the sale or purchase of a security.” Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 542 (2003).

186. Bodie, *supra* note 185, at 542.

187. *See* Choi, *supra* note 23, at 310–19.

188. *Id.* at 312–13.

189. *Id.*

190. *Id.* at 313.

191. *Id.* at 316.

criticized by legal scholars and investors alike.<sup>192</sup> Second, commentators have disagreed intensely over the Commission's proposed revisions to the accredited investor definition.<sup>193</sup> Third, tremendous growth in the hedge fund industry has resulted in hedge funds becoming more popular and influential within the securities market, with more investors now investing in them.<sup>194</sup> As such, it is likely that as the pool of hedge fund investors grows, it would include unsophisticated individuals who cannot fend for themselves, and therefore, a more protective definition may be needed.<sup>195</sup> Fourth, the existing scholarly proposals for alternative investor classification schemes and regulatory regimes are flawed.<sup>196</sup>

In light of this, I propose that the Commission adopt a licensing scheme which supplements the current accredited investor definition. Such a proposal would solve the problems of the current definition, meet the objectives of the federal securities regime, and avoid the flaws identified in the alternative scholarly proposals. In Part (A) of this proposal, I describe my licensing scheme, which incorporates two licensing exams: one for those natural persons who are accredited investors under the current definition, and one for those natural persons who are unaccredited investors under the current definition. In Part (B), I survey the shortcomings of the current accredited investor definition. I also detail how my proposal overcomes these shortcomings and effectuates the intent of the Commission in enacting Regulation D. In Part (C), I examine how my proposed licensing scheme is superior to scholarly alternatives. In Part (D), I confront potential criticism and drawbacks to my proposed licensing scheme.

#### A. *The Licensing Scheme*

Under my proposed licensing scheme, there would be two different licensing exams available: one exam for those natural persons who are accredited investors under the current definition, and one exam for those natural persons who are unaccredited investors under the current definition. This proposed licensing scheme attempts to synthesize a realistic measure of an investor's "knowledge and experience in financial

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192. See *supra* notes 108–25 and accompanying text.

193. See Securities Act Release No. 33-8766, 72 Fed. Reg. 400 (proposed Jan. 4, 2007); Securities Act Release No. 33-8828, 72 Fed. Reg. 45116 (proposed Aug. 10, 2007); see also *supra* notes 14–16, 21–22.

194. See *supra* notes 25–26, 99–107 and accompanying text.

195. See *supra* note 105 and accompanying text.

196. See *supra* notes 126–59, 167–90 and accompanying text.

and business matters,” which in turn gauges whether the investor is “capable of evaluating the merits and risks of the prospective investment.”<sup>197</sup>

### 1. *The Unaccredited Investor Licensing Exam*

Under my proposal, the unaccredited investor licensing exam would be the default option available for all natural persons interested in purchasing interests in a private offering. There would be no net worth or income threshold that must be met to take the exam.

This exam, longer and more intensive than the accredited investor licensing exam, would be adapted from portions of the information covered by the Series 82 exam under “Regulation of The Market for Registered and Unregistered Securities.”<sup>198</sup> The Series 82 exam is the Limited Representative-Private Securities Offerings Qualification Examination, which is used to qualify individuals for the sale of private placement securities as part of a primary offering.<sup>199</sup> My proposed exam would cover the following information: types of offerings (including primary, secondary, private placement, Rule 144A, and Regulation S), pricing of the issue (including market condition, industry conditions and issuer needs), exempted securities, and exempted transactions (including statutory exemptions, Regulation D, and the rules thereunder). Natural persons taking the unaccredited investor’s licensing exam would be required to get a passing score of seventy percent.<sup>200</sup> A passing score would allow the Commission to confidently determine that an investor is, in fact, financially knowledgeable and sophisticated.

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197. See Rule 506, 17 C.F.R. § 230.506 (2007). For additional information on Rule 506, see *supra* note 57.

198. See FINANCIAL INDUSTRY REGULATORY AUTHORITY, PRIVATE SECURITIES OFFERINGS QUALIFICATION EXAMINATION (TEST SERIES 82) STUDY OUTLINE (2007), available at [http://www.finra.org/web/groups/corp\\_comm/documents/home\\_page/p011064.pdf](http://www.finra.org/web/groups/corp_comm/documents/home_page/p011064.pdf).

199. The exam is administered by the Financial Industry Regulatory Authority (FINRA), which is a non-governmental agency which regulates all securities firms doing business in the United States. See FINRA, About the Financial Industry Regulatory Authority, <http://www.finra.org/AboutFINRA/CorporateInformation/index.htm>. (last visited Dec. 22, 2008). FINRA prepares a study outline for each qualification exam it administers. It should be noted that the Commission is currently proposing modifications to the Series 82 study outline and exam, but these modifications do not affect the information covered under section 2 of the outline (entitled “Regulations of The Market for Registered and Unregistered Securities”). See Securities Exchange Act Release No. 34-57079, 92 SEC Docket 931, 931 (Dec. 31, 2007).

200. Seventy percent is a passing score for the Series 82, as well as the other exams offered to investment management professionals. See NASD Notice to Members 02-27, Membership and Registration Rules (2002), available at [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003681.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003681.pdf).

If an investor fails to pass the licensing exam, the investor would be treated as unaccredited until he or she is able to retake the licensing exam at a later date and pass. Investors who are treated as unaccredited due to a failing exam score would likely not be able to participate in private offerings, as it is generally not cost effective for issuers to provide the required disclosure materials for unaccredited investors.<sup>201</sup>

## 2. *The Accredited Investor Licensing Exam*

Before a natural person first takes the accredited investor licensing exam, he or she would have to meet the wealth requirements currently incorporated into the accredited investor definition: (1) individual or joint net worth of \$1,000,000, or (2) “individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years with a reasonable expectation of reaching the same income level in the current year.”<sup>202</sup> Only after accredited investor status has been demonstrated would a natural person be required to demonstrate sophistication through a short licensing exam.

The purpose of having a less stringent test for those investors who meet the accreditation requirements under the current definition is that, while wealth is a flawed *proxy* for sophistication, wealth can be *suggestive* of sophistication.<sup>203</sup> Furthermore, wealth may be indicative of an investor’s ability to absorb financial risk<sup>204</sup> and therefore is one factor among many that should be assessed to determine financial acumen under the proposed licensing scheme. Finally, while an accredited investor may be subjected to a less stringent licensing exam, being subject to an exam is still better than getting a free pass based solely on net worth or income. A less stringent accredited investor exam may be imperfect, but in the long run, this system’s efficiency outweighs the risk of letting a hapless investor be deemed accredited based solely on income or net worth. It should also be noted that the very fact that an investor may have to take an exam may deter an unsophisticated investor from recklessly investing, thus making such an investor far less vulnerable than if he or she were automatically qualified to participate. Additionally, having an exam for current

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201. See Preiserowicz, *supra* note 57, at 815.

202. Rule 501(a), 17 C.F.R. § 230.501(a) (2007).

203. See Fletcher, *supra* note 23, at 1151–52.

204. See *Position Papers Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 BUS. LAW. 483, 491 (1975).

accredited investors is desirable, but there is a cynical reason to make the accredited investor exam less stringent: current accredited investors would be less likely to protest the proposed licensing scheme if they are not subject to the same standards as unaccredited investors.

Such an exam would test knowledge of the concepts of public and private offerings, issuers and purchasers, and basic securities regulations. The exam would cover primarily the same material as the unaccredited investor licensing exam, but would have fewer questions and be less intensive. This would ensure that purchasers are financially sophisticated investors who are aware of the risks and merits inherent in participating in investing. Investors would be required to get a passing score of seventy percent to be licensed.<sup>205</sup>

*B. The Proposed Licensing Scheme Solves the Problems with the Current Accredited Investor Definition and Effectuates the Commission's Intent*

Such a licensing scheme solves the problems and shortcomings of the current accredited investor definition. By implementing this proposal, the accredited investor concept would not suffer from under- or overinclusiveness.<sup>206</sup> Under this licensing scheme, a recent business school graduate, heavily burdened with student loan debt, would be able to demonstrate her financial sophistication and be deemed an accredited investor even though she likely would not meet the current minimum accredited investment wealth requirements. Additionally, under this licensing scheme, a high school drop-out, with no business or investment knowledge, who recently won the state lottery's \$50 million dollar jackpot would not be able to rely on her winnings, but rather would have to demonstrate financial sophistication by taking the accredited investor licensing exam.

This proposed licensing scheme also effectuates the Commission's intent in enacting Regulation D: it would bring certainty to the private offering so that issuers can confidently determine whether an investor may participate.<sup>207</sup> Under this proposal, once purchasers are licensed they would simply note their license number on their paperwork. That license number could be cross-referenced against a central database of purchasers

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205. See *supra* note 200.

206. See Choi, *supra* note 23, at 310.

207. The Commission's goal in enacting Regulation D was "to bring certainty to private offerings such that issuers could engage in private offerings with confidence that the planned offering would not run afoul of the 1933 Act's registration requirements under § 5." Paredes, *supra* note 23, at 997 n.91; see also *supra* notes 27–81.

permitted to participate in private offerings. The issuer would, with confidence, know that the purchaser was allowed to participate in the private offering. This is similar to how one may look up an attorney's bar number to ensure that the attorney is licensed to practice law in a particular jurisdiction.

In addition, this licensing scheme is also in line with the SEC's goal of providing investor protection, since natural persons would not be allowed to participate in a private offering unless they can prove in a written exam that they are aware of the risks and merits inherent in investing in a private offering. As such, those investors who are not capable of understanding the risks and merits, and in turn, not able to protect themselves, would not be permitted to participate until they are capable of doing so.

Finally, a licensing scheme would encourage and increase investor education, resulting in a more sophisticated and savvy marketplace. As potential investors prepare for either of the two licensing exams, they would become more familiar with the risks and merits of investing, securities regulation, and private offering exemptions under Regulation D. In addition, investors would be required to keep their license current through periodic continuing investor education courses. This would also serve to increase purchaser education levels and keep investors abreast of changes in the securities regulatory regime or the financial markets.

### *C. The Proposed Licensing Scheme is Superior to the Proposed Scholarly Alternatives*

The proposed licensing scheme is superior to the scholarly alternatives advanced by Stephen Choi, C. Edward Fletcher III, and Howard M. Friedman. Under my proposed licensing scheme, investors would not be subject to unwarranted and unwanted restrictions, such as those Choi would impose on unsophisticated investors.<sup>208</sup> Rather, investors would be subject to restrictions only if they do not have appropriate financial sophistication or fail to educate themselves, such that they fail the licensing exam. Of course, just as with Choi's licensing scheme,<sup>209</sup> my proposal may be vulnerable to error. For example, an investor may be subjected to unwarranted or unwanted restrictions due to testing error, or

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208. See *supra* notes 167–69 and accompanying text. Choi determines that an alternative investor classification scheme is necessary because the current federal securities regime is too restrictive. See Choi, *supra* note 23, at 280–81. But Choi's alternative investor classification scheme still subjects investors to unwanted restrictions, such as allowing unsophisticated investors to transact only in passive index mutual funds. *Id.* at 301.

209. *Id.* at 313.



an investor may fail to pass the licensing exam, even though he or she is financially knowledgeable. However, it is unlikely that scoring error would play so prominent a role as to make the licensing scheme unreasonable.<sup>210</sup> Additionally, should an investor fail to pass the licensing exam even though he or she is financially knowledgeable, he or she may retake the exam at a later date.

My proposed licensing scheme does not suffer from the problem of potentially untrustworthy or unknowledgeable informational resources, as does Choi's knowledge-based investor classification scheme.<sup>211</sup> Here, investors are not dependent on intermediaries as they are within Choi's scheme.<sup>212</sup> Investors may choose to rely upon an intermediary once they have passed the licensing exam, in which case the same concerns present in Choi's investor classification scheme would be relevant. But presumably, because these investors have passed an exam which tests financial sophistication, such investors would be knowledgeable enough to avoid being victimized by con artists.

Additionally, unlike Fletcher's sophistication factors,<sup>213</sup> my proposed licensing scheme presents a realistic, quantifiable gauge of sophistication. Exam scores would be calculated by computer, and accreditation would be measured by a passing score of seventy percent. Also, under this scheme, the Commission would not be relying upon a purchaser honor system, wherein investors attest to how much financial television programming they watch.<sup>214</sup> While there is room for computer error under the proposed licensing scheme, there would not be room for human manipulation via dishonesty as there would be with a purchaser honor system.

Unlike Friedman's proposal for increased emphasis on broker-dealer regulation,<sup>215</sup> which covers only those investors who utilize brokers, my proposed licensing scheme is more far reaching in scope, covering all potential investors regardless of their choice to utilize a broker.

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210. During the summer of 2007, several people taking the New York State Bar Exam experienced technical difficulties. See Huliq News, *New York Bar Exam Results*, available at <http://www.huliq.com/42128/new-york-bar-exam-results> (last visited Jan. 3, 2009). Such technical difficulties have not derailed the future administration of the New York State Bar Exam.

211. See *supra* notes 170–71 and accompanying text.

212. See Choi, *supra* note 23, at 301. Under Choi's investor classification scheme, intermediary-level investors are required to associate with appropriate intermediaries, who may not be trustworthy, unfaithful or negligent in their screening duties. *Id.* at 290, 295–96.

213. See *supra* notes 175–76 and accompanying text.

214. See *supra* notes 175–76 and accompanying text. Some of Fletcher's sophistication factors are problematic because there are no realistic means for the Commission to measure these factors, beyond the possibility of a purchaser honor system, which is vulnerable to fraud. See *supra* note 175 and accompanying text.

215. See *supra* notes 155–59 and accompanying text.

Finally, my proposed licensing scheme avoids the untenable suggestion implicit in Choi's self-tailored investor regulation system that the current federal securities regime be dismantled.<sup>216</sup> My scheme merely supplements the existing federal securities regime. Such a licensing scheme would permit the Commission to maintain its useful regulatory rules, such as Rule 10b-5 under the 1934 Act, which protects holders of securities against fraud or deceit in the purchase or sale of securities.<sup>217</sup>

#### *D. Potential Criticisms of the Proposed Licensing Scheme*

As with Choi's licensing scheme,<sup>218</sup> there are administrative costs and complexities inherent in such a system. There would be administrative costs involved with designing the exam and the educational materials used to prepare for it. There would also be costs involved with administering the exam: testing centers would need to be created, testing computers would need to be purchased, and test proctors would need to be hired. But, the efficiency gains associated with licensing financially sophisticated individuals far outweigh the administrative costs of the current accredited investor definition, which likely include costly fraud proceedings against con artists and the simple costs of honest mistakes made by uneducated investors who are in over their heads.

Additionally, there would be opportunity costs associated with such a licensing scheme. Investors would have to forego purchasing activity while they expend time preparing for the licensing exam. However, if investors are financially knowledgeable, preparation time should be minimal, and if investors are not financially knowledgeable, then any time spent preparing for the exam rather than recklessly investing is time well spent.

Another potential criticism is that investors would study for the exam to pass, rather than to gain financial acumen. It is possible that, much like the SAT test prep industry prepares students to take a test, rather than educating them on broader concepts, the accredited and unaccredited licensing exam test-preparation industry would do the same. In such a scenario, investors would not increase their understanding of the financial markets, securities regulation, and the private offering exemption under Regulation D, but instead would learn just enough about the particulars to pass the exam. To the extent this is true, such investors might remain

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216. See *supra* notes 184–85 and accompanying text.

217. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007).

218. See Choi, *supra* note 23, at 312–13.

vulnerable to the risks and abuses of the system that the Commission has sought to protect them from. To combat this concern, the Commission could take care in designing the tests, making sure to include a broad range of concepts and question types. By testing a wide range of subjects, using different question formats, it would be hard for the test prep industry to come up with a stock course specifically for the licensing exams. Rather, the test prep industry would be forced to create a course which teaches all of the different subjects covered on the exam, which would ensure that investors truly are gaining financial knowledge by reviewing for the exam.

Currently, Rule 506 permits issuers to include up to thirty-five unaccredited investors in their offerings. In practice, however, funds rarely include such unaccredited investors, because the burden of disseminating the required disclosure to these unaccredited investors often outweighs the benefit gained from inclusion.<sup>219</sup> Such a de facto exclusion could occur under my proposed licensing regime, as well. For example, private investment vehicles could establish an investment minimum that would be cost prohibitive to purchasers capable of investing only a small amount. Thus, even though individuals who pass the unaccredited licensing exam would be accredited, hedge funds could nonetheless exclude these investors.

While these criticisms and concerns are relevant, they are not insurmountable and should not deter the Commission from adopting the proposed licensing scheme discussed here. Any accreditation regime would be subject to inherent criticism and concerns. People will be excluded who should not be, and likewise, people will be included who should not be. However, the benefits of having a financially sophisticated accredited investor counterbalance these concerns.

## V. CONCLUSION

Recent proposed revisions to the current accredited investor definition for natural persons and the exponential growth of the hedge fund industry make it clear that a review of the accredited investor definition for natural persons is relevant and that adjustments are necessary. While legal

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219. While Rule 505 and Rule 506 allow for issuers to issue their interests to up to thirty-five unaccredited investors, the Commission recognized that in practice, "most hedge funds sell only to investors whose wealth exceeds that required to meet the standard established for accredited investor status." SEC STAFF REPORT, *supra* note 25, at x. For additional information regarding Rules 505 and 506, see *supra* note 57.

scholars have proposed wholesale alternatives to the current accredited investor definition, the SEC should adopt a hybrid licensing scheme to supplement the current accredited investor definition rather than replace it. Such a proposal is in line with the Commission's objective to create a clear, bright-line standard that increases investor protection and encourages investor education. However, it may result in administrative costs and opportunity costs, and it may not work perfectly in practice because private investment vehicles may still exclude small investors. While such a proposal may result in certain new costs and may be incomplete in alleviating the ills of the current system, it may just be the "least imperfect" solution to a pressing problem and should be embraced by the Commission.

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