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Redefining Accredited Investor: That's One Small Step for the SEC, One Giant Leap for Our Economy

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REDEFINING ACCREDITED INVESTOR: THAT'S ONE SMALL STEP FOR THE SEC, ONE GIANT LEAP FOR OUR ECONOMY*

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* Inspired by a 50-year-old quote from Neil Armstrong. *See* Olivia B. Waxman, *Lots of People Have Theories About Neil Armstrong's 'One Small Step for Man' Quote. Here's What We Really Know*, TIME (July 15, 2019), https://time.com/5621999/neil-armstrong-quote/ ("At 10:56 p.m. ET on July 20, 1969, the American astronaut Neil Armstrong put his left foot on the lunar surface and famously declared, 'That's one small step for man, one giant leap for mankind.'").

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INTRODUCTION

It may sound trivial, yet how we define accredited investor (AI) is critical. Among other things, U.S. securities laws and regulations make it easier for AIs to invest in privately held companies through "exempt offerings," which are offerings not "registered" under the 1933 Securities Act.[1] This results in AIs having investment opportunities that are unavailable to non-accredited investors (non-AIs).[2] Moreover, the amount raised in exempt offerings has been increasing both absolutely and relative to the amount raised in registered offerings.[3] In fact, the Director of the SEC's Division of Corporate Finance recently indicated that "[c]ompanies raised $2.9 trillion in private markets [in 2018], compared to $1.4 trillion in public markets . . . ."[4] The importance of making more exempt offerings available to current non-AIs is frequently noted.[5] Further, the pool of capital available to new ventures is essentially limited to the amount AIs are willing and able to invest.[6] This is because it is too expensive for new ventures to participate in registered (i.e., public) offerings.[7] It is also well established that these entrepreneurial ventures, which frequently need additional capital,[8]

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1. *See* SEC Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460, 30,470 (proposed Jun. 26, 2019) (to be codified at scattered parts of 17 C.F.R.).

2. *Id.*

3. *Id.* at 30,465.

4. Tom Zanki, *Changes to Accredited Investor Rules Take Priority at SEC*, LAW360 (Aug. 13, 2019, 7:03 PM), https://www.law360.com/compliance/articles/1188099/changes-to-accredited-investor-rules-take-priority-at-sec.

5. *See, e.g.*, Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals*, WALL ST. J. (Aug. 30, 2018, 4:54 PM), https://www.wsj.com/articles/sec-chairman-wants-to-let-more-main-street-investors-in-on-private-deals-1535648208 ("The Securities and Exchange Commission wants to make it easier for individuals to invest in private companies, including some of the world's hottest startups, the agency's chairman said in an interview.").

6. *See* Laura Anne Lindsey & Luke C.D. Stein, *Angels, Entrepreneurship, and Employment Dynamics: Evidence from Investor Accreditation Rules* 1 (Jan. 1, 2019) (unpublished manuscript), https://ssrn.com/abstract=2939994.

7. Companies have a choice when issuing their securities: (i) register the securities with the SEC or (ii) find an exemption from registration. *See, e.g.*, PWC, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE? INSIGHT INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 12 (2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf. However, registering securities with the SEC is cost prohibitive for new ventures. *See id.* at 5 ("The road to becoming a public company can be long and costly . . . almost 83% of CFOs participating in the survey indicated that their firms spent more than $1million on one-time costs associated with the initial public offering."). The costs of staying public are also problematic for new ventures. *See id*. at 14 ("In addition to the costs associated with going public—the offering and incremental organizational costs— there are significant expenses related to the process of being public . . . [t]wo-thirds of the CFOs surveyed estimated spending between $1 million and $1.9 million annually on the costs of being public.").

8. *See, e.g.*, VICTOR HWANG, SAMEEKSHA DESAI & ROSS BAIRD, ACCESS TO CAPITAL FOR ENTREPRENEURS: REMOVING BARRIERS 4 (2019), https://www.kauffman.org/what-we-

have a significant impact on our economy.[9] Thus, converting current non-AIs into AIs would create new investment opportunities, provide a much needed source of capital for entrepreneurial ventures, and have an economic impact.

To date, the AI definition has ignored the sophistication of individual investors. Instead, it has focused solely on one's net worth and income.[10] Commentators, including the SEC, have repeatedly noted potential shortcomings with this approach.[11] But, the need to protect investors has provided the justification for tolerating these shortcomings.[12] This Article argues that AI should be redefined to welcome investors who demonstrate an ability to fend for themselves by passing a relevant exam. More specifically, Part II of this Article reviews the current AI definition and population. Part III provides examples of how the AI definition impacts investments in private companies and the secondary trading of such securities. Part IV summarizes recent proposals to expand the current AI definition. Finally, Part V takes an in-depth look at one of the proposals: letting investors test into AI status. Part V also explains how such an exam could be linked to two other responsible ways to expand the AI pool: putting investment limits on AIs and recognizing the value of experience gained by actually investing in exempt offerings.[13]

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do/entrepreneurship/research/capital-landscape-report ("The vast majority of entrepreneurs need financing to assist with these start-up costs and to grow their businesses. Data from the 2016 Annual Survey of Entrepreneurs shows that only between 5 and 10 percent of businesses that have paid employees do not need financing at startup. Between 90 and 95 percent of entrepreneurs that hire, then, require some amount of financing to start their businesses.") (footnote omitted).

9. *See id.* at 3 ("Entrepreneurship plays an important role in economic dynamism in the United States. Entrepreneurial ventures serve as the workhorse for the economy by contributing jobs, fueling innovation, and adding productivity. Startups in the United States less than one year old are especially important for net new job creation." (footnote omitted)); *see also* U.S. Sec. & Exch. Comm'n, Opinion Letter on Recommendations Regarding the Accredited Investor Definition (July 20, 2016), https://www.sec.gov/info/smallbus/acsec/acsec-recommendations-accredited-investor.pdf (Noting in consideration #2: "[e]merging companies play a significant role as drivers of U.S. economic activity, innovation and job creation. Their ability to raise capital in the unregistered securities markets is critical to the economic well-being of the United States.").

10. Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 733–34 (2009).

11. *See infra* Part II.

12. *See, e.g.*, Cydney Posner, *What Happened at the Small Business Capital Formation Roundtable and Advisory Committee Meeting?,* COOLEY PUBCO (May 6, 2019), https://cooleypubco.com/2019/05/06/small-business-roundtable-and-committee-meeting/ ("At the Small Business Capital Formation Advisory Committee, SEC Chair Jay Clayton stressed the importance of allowing retail investors to participate in early stage investments; however, from an investor protection standpoint, a key is to ensure that the interests of retail investors are aligned with those of management and the institutional investors."). *But see* U.S. Sec. & Exch. Comm'n, *supra* note 9 (Noting in consideration #7: "[s]ome commentators have urged that the accredited investor thresholds be increased in order to prevent fraud against investors who may be unable to fend for themselves. The Committee is not aware of any evidence suggesting that fraud in the private markets is driven or affected by the levels at which the accredited investor definition is set.").

13. *See infra* Part IV.D.

I. CURRENT ACCREDITED INVESTOR DEFINITION AND POPULATION

The AI definition is set forth in Rule 501(a) of Regulation D under the Securities Act of 1933.[14] Rule 501(a) provides for several categories of AIs, including banks, organizations described in section 501(c)(3) of the Internal Revenue Code, trusts, and other entities that meet the applicable asset or other re-requirement(s).[15] However, for natural persons (i.e., individual investors), whether one is an AI will almost always boil down to the amount of his/her net worth or income.[16] More specifically, under Rule 501(a)(5), an AI includes: "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000"[17] provided that "[t]he person's primary residence shall not be included as an asset"[18] and "[i]ndebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability . . . ."[19] Thus, under this "Net Worth Threshold" one's net worth must exceed $1 million, excluding the value of the equity in his/her residence. Moreover, under Rule 501(a)(6)'s "Income Thresholds," an AI includes: "[a]ny natural person 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."[20]

The SEC estimates that 9.4% of U.S. households qualify as AIs by meeting the Net Worth Threshold while 8.9% and 4.6% of U.S. households qualify as AIs under the individual and joint Income Thresholds, respectively.[21] Overall, the SEC estimates that 13% of U.S. households qualify as AIs.[22] Because household net worth and incomes tend to be much higher in the Northeast and West, more AIs are located in those two regions (when compared to the Midwest and South).[23] Importantly, 13% is an estimate of the total pool of AIs in

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14. 17 C.F.R. § 230.501(a) (Westlaw through 85 FR 11270).

15. *Id.*

16. *See id*. *But see* 17 C.F.R. § 230.501(a)(4) (Westlaw through 85 FR 11270) (indicating "[a]ny director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer" is included in the definition of AI regardless of whether the individual meets the requirements of a natural person in Rule 501(a)(5)).

17. 17 C.F.R. § 230.501(a) (Westlaw through 85 FR 11270).

18. *Id.*

19. *Id*.

20. *Id.*

21. Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,471.

22. *Id.*

23. *Id.*

the U.S. only a small portion of this total pool actually invests in exempt offerings.[24]

Moreover, AIs who are natural persons who invest in new ventures, often called angel investors or "angels," play a unique role in the entrepreneurial finance ecosystem. This is because venture capital (VC) is not an easy substitute for angel investments, even in sectors where VC is active.[25] Similarly, banks are an imperfect substitute for angel investments.[26] Therefore, as the number of natural persons who are AIs increases or decreases, the amount of capital available to entrepreneurs should also increase or decrease, respectively, since other funding sources are poor substitutes for angel investments.[27]

To summarize, the current AI definition uses only financial criteria (i.e., net worth and income levels) to determine whether natural persons are AIs. No consideration whatsoever is given to other factors such as one's education, professional certifications, or experience. Therefore, private companies can raise capital from clueless individuals who are rich but not from middle class individuals who are financially sophisticated, even if these individuals get paid to make decisions for prestigious VC firms or advise wealthy individuals on private company investments.[28] Moreover, under the current AI definition, 87% of U.S. households are non-AIs and, of the 13% of households that do qualify as AIs, only a small fraction is likely to actually participate in exempt offerings.[29] Further, the amount of capital available to many entrepreneurial ventures depends on the number of these participating households since other traditional capital sources, such as VC funds and banks, are unlikely to provide alternative financing.

II. IMPLICATIONS OF THE ACCREDITED INVESTOR DEFINITION

Under existing securities laws, there are several ways the AI definition impacts the number of investment opportunities available to natural persons and the amount of capital available to entrepreneurial ventures. This Part II provides specific examples of how the AI definition relates to primary offerings (i.e., when issuing companies sell securities directly to individual investors), secondary offerings (i.e., when individual investors sell securities to each other), and other situations involving securities laws. These examples should help illustrate the current, real-world implications of the AI definition.

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24. *Id*.; *see also* Posner, *supra* note 12 (referring to an estimate that only "300,000 out of 10M eligible accredited investors" (i.e., only 3% of AIs) actually participate in private investments).

25. Lindsey & Stein, *supra* note 6, at 4.

26. *Id.* at 6 (citation omitted).

27. *Id.* at 8.

28. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 310 (2000).

29. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1; *see* Posner, *supra* note 14.

A. *Primary Offerings*

Regulation D originated as an effort to facilitate capital formation while protecting investors.[30] In 1982, the SEC adopted Rule 506 of Regulation D to provide objective standards on which issuers can rely to meet the requirements of the Section 4(a)(2) exemption from registration.[31] Prior to the JOBS Act, issuers relying on the Rule 506 exemption could not attract potential investors through a general solicitation (i.e., advertising).[32] However, in 2012, Section 201(a) of the JOBS Act required the SEC to permit general solicitations under Rule 506 in cases where all purchasers of the securities are AIs and the issuer takes "reasonable steps" to verify that the purchasers are AIs.[33] This resulted in Rule 506 essentially splitting into two separate exemptions: the Rule 506(b) exemption, which does not permit issuers to engage in advertising, and the Rule 506(c) exemption, which permits issuers to engage in advertising but only allows sales to AIs and requires issuers to take the aforementioned reasonable steps.[34] Both of these exemptions are significant. For example, Rule 506(b) dominates the market of exempt offerings and, in 2018, more capital was raised under Rule 506(b) alone than was raised pursuant to registered offerings.[35] Moreover, while Rule 506(c) offerings are not as popular as Rule 506(b) offerings, issuers raised $466.4 billion under Rule 506(c) from September 23, 2013 (the date Rule 506(c) offerings became effective) through December 31, 2018.[36] Further, as stated above, Rule 506(c) offerings give issuers a unique tool—the

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30. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1 at 30,480.

31. *See id*. at 30,480 & nn. 185–86.

32. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1.

33. *Id*. With respect to the Income Threshold, issuers can comply with the "reasonable steps" requirement by reviewing IRS tax forms reporting a purchaser's income for the two most recent fiscal years and obtaining a written representation that he/she has a reasonable expectation of reaching the required income level during the current year. *See Keeping Current: SEC Staff Issues Guidance on Verifying Accredited Investor Status*, BUSINESS LAW TODAY (Aug. 14, 2014), https://www.americanbar.org/groups/business_law/publications/blt/2014/08/keeping_current/ (citing Rule 506(c)(2)(ii)(A)). With respect to the Net Worth Threshold, issuers must review specified documentation evidencing the purchaser's assets and liabilities dated within the prior three months and obtain a written purchaser representation that all liabilities necessary to make a determination of net worth have been disclosed. *Id*. (citing Rule 506(c)(2)(ii)(B)). While issuers desire to use "safeguards" like these for purposes of clarity and certainty (i.e., there is certainty purchasers will be considered AIs, and thus permit reliance on the Rule 506(c) exemption), there are burdens associated with these methods to verify AI status and purchasers have legitimate privacy concerns. *See, e.g.*, Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,482–83; *see also* Peter Rasmussen, *Analysis: Rule 506(c)'s General Solicitation Remains Generally Disappointing*, BLOOMBERG ANALYSIS (May 26, 2017), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-rule-506cs-general-solicitation-remains-generally-disappointing.

34. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,480–85.

35. *Id*. at 30,484 ("In 2018, the amount raised by Rule 506(b) offerings, $1.5 trillion, was larger than the $1.4 trillion raised in registered offerings.").

36. *Id*. at 30,484 tbl. 6.

ability to advertise exempt offerings to the public (even though actual sales can only be to AIs).[37] One benefit of Rule 506(b) and Rule 506(c) offerings is that issuers using these exemptions are not required to register or qualify the offerings with state securities regulators (i.e., any such state law requirements are "preempted" with respect to issuances of these "covered securities").[38]

Because sales under Rule 506(c) can only be to AIs, the AI definition has strong implications for Rule 506(c). That is, the universe of AIs is also the universe of potential purchasers in Rule 506(c) offerings.[39] However, the AI definition also has implications for Rule 506(b) offerings. While Rule 506(b) permits sales to AIs and up to 35 non-AIs, disclosure requirements (i.e., information issuers must furnish when raising capital) become more extensive if any non-AIs are included in the offering.[40] Thus, a vast majority of issuers limit their Rule 506(b) offerings exclusively to AIs in order to avoid the additional disclosure requirements and the associated costs.[41] In fact, non-AIs only participated in "approximately 6% of Rule 506(b) offerings in 2015, 2016, 2017, and 2018, which offerings reported raising between two and three percent of the total capital raised under Rule 506(b) in each of 2015, 2016, 2017, and 2018."[42] Therefore, converting non-AIs to AIs should make Rule 506(b) and Rule 506(c) offerings even more widespread.

Rule 506 offerings are not the only primary offering exemptions impacted by the AI definition. Regulation A provides another example of how the AI definition effects primary offerings. Regulation A, originally adopted by the SEC in 1936, was amended by Section 401 of the JOBS Act.[43] On March 25, 2015, the SEC adopted final rules to implement Section 401 by creating two tiers of Regulation A offerings: Tier 1, for up to $20 million in a 12-month period; and Tier 2, for up to $50 million in a 12-month period.[44] Moreover, there are no restrictions on resale for securities sold in either a Tier 1 or Tier 2 offering.[45] Further, while Tier 2 offerings are subject to additional Federal filing and reporting requirements when compared to Tier 1 offerings, they (like Rule 506 offerings) preempt state registration and qualification requirements.[46] This state preemption makes Tier 2 offerings attractive to issuers. However, unlike AIs,

37. *Supra* note 33.

38. 15 U.S.C. § 77r(b)(4)(F) (2019).

39. Thus, expanding or contracting the size of the AI population causes an equal change to the population of potential participants in Rule 506(c) offerings.

40. *See* 17 C.F.R. § 230.502(b)(1) (2019).

41. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,484.

42. *Id*. (footnote omitted).

43. *Id.* at 30,486 (footnotes omitted).

44. *Id.* at 30,486–87 (citing Regulation A, 80 Fed. Reg. 21806 (April 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, and 260)); *see also* 17 C.F.R. § 230.251.

45. *Id.* at 30,487.

46. *Id.* at 30,491.

non-AIs are limited as to how much they can invest in a Tier 2 offering. Specifically, non-AIs participating in a Tier 2 offering can invest no more than: (a) 10% of the greater of annual income or net worth (for natural persons); or (b) 10% of the greater of annual revenue or net assets at fiscal year-end (for non-natural persons).[47] Thus, to the extent non-AIs convert to AIs, the amount of capital available for Regulation A, Tier 2 offerings will increase.[48]

B. *Secondary Offerings*

While primary offerings are critical to entrepreneurial ventures, secondary offerings are also important. Among other things, as it becomes easier for investors to resell their private company stock, they are more likely to: (i) invest in primary offerings in the first place, (ii) diversify their portfolios, and (iii) reallocate their capital to more attractive investment opportunities.[49] Similarly, increased liquidity makes it easier for businesses to attract capital and at a lower cost.[50] However, in order to resell their securities, investors must either register (or have the issuer register) the transaction or have an exemption from registration.[51] As was the case with primary offerings, exemptions and the AI definition are both important with respect to resales. Two specific examples of the AI definition's impact on secondary offerings are provided in this Part II.B: resales of Regulation Crowdfunding securities and resales relying on the Section 4(a)(7) exemption.

In 2012, Title III of the JOBS Act provided a new exemption from registration by adding Section 4(a)(6) to the Securities Act.[52] To implement Title III,

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47. 17 C.F.R 230.251(d)(2)(i)(C); *see also* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1 (this limit does not apply to purchases of securities listed on a national securities exchange).

48. The author is not suggesting current non-AIs who convert to AIs *should* typically put more than 10% of the greater of their annual income or net worth into a Tier 2 offering. Nevertheless, the ability to do so (and thus the total amount of potential capital available for such offerings) will hinge on whether one is an AI.

49. *See* U.S. Sec. & Exch. Comm'n, Opinion Letter on Recommendation Regarding Secondary Market Liquidity for Regulation A, Tier 2 Securities (May 15, 2017), https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-secondary-liquidity-recommendation.pdf (noting consideration (ii): "[s]econdary market liquidity is integral to capital formation. Small businesses trying to attract capital often struggle because potential backers are reluctant to invest unless they are confident there will be an exit opportunity. Capital is often more expensive or not available for issuers that are not able to provide investors with secondary market liquidity. Also, securities lacking an available market generally bear an illiquidity discount on value." Further, noting consideration (iii): "[l]imited possibilities for liquidity means investors' capital may be locked up longer than they would like, hindering their ability to build portfolios with multiple, diverse investments. Liquidity limitations also prevent capital from being put to use in the next investment.").

50. *Id.*

51. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1 at 30,517.

52. *See* 15 U.S.C. 77d(a)(6).

the SEC adopted "Regulation Crowdfunding," which became effective on May 16, 2016.[53] To qualify for the exemption, several requirements must be met including: (i) limits on the amount issuers can raise; (ii) limits on the amount people may invest; (iii) the transactions must be conducted through a registered intermediary; and (iv) the issuers and intermediaries must provide information to the purchasers and the SEC.[54] Regulation Crowdfunding also provides an example of how the AI definition impacts secondary offerings. Specifically, securities purchased in a Regulation Crowdfunding transaction generally cannot be *resold* for a period of one year, unless, the securities are sold to an AI or a limited number of other permitted transferees.[55] Thus, increasing the number of AIs would increase the number of permitted transferees for the one-year period and thus increase the liquidity of secondary markets.

In 2015, the FAST Act created a new statutory exemption for *resales* of securities by adding Section 4(a)(7) to the Securities Act.[56] In addition to providing a Federal exemption, Section 4(a)(7) preempts state registration and qualification requirements.[57] However, the Section 4(a)(7) resale exemption is only available when the purchaser is an AI.[58] Therefore, while several other requirements of Section 4(a)(7) must still be met,[59] increasing the number of AIs

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53. *See* Crowdfunding Release, 80 Fed. Reg. 71,387 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, and 274).

54. *See* 17 C.F.R. § 227.100.

55. *See* 17 C.F.R. § 227.501. Other permitted transferees include the issuer, the purchaser's family members, and certain trusts; moreover, transfers are also permitted if made as part of a registered offering, or in connection with the death or divorce of the purchaser. *See id*.

56. *See* SEC Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,519; *see also* Albert Lung & Joanne R. Soslow, *Federal Securities Law Implications of the FAST Act*, MORGAN, LEWIS & BOCKIUS LLP (Dec. 23, 2015), https://www.morganlewis.com/pubs/federal-securities-law-implications-of-the-fast-act.

57. *Id.*

58. *Id.* Without this preemption, an investor seeking to resell securities would also need to comply with any State securities registration and qualification requirements.

59. Further, securities acquired under Section 4(a)(7) are "restricted securities" and cannot be *further* transferred without registration or another exemption. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,519 (also summarizing six additional requirements of Section 4(a)(7): "[1] Neither the seller, nor any person acting on its behalf, uses any form of general solicitation or advertising; [2] Neither the seller nor any person who has been or will be paid for its participation in the transaction is a "bad actor" under Rule 506(d); [3] The issuer is engaged in business, not in the organizational stage or in bankruptcy or receivership, and is not a blank check, blind pool, or shell company that has no specific business plan or purpose and has not indicated that its primary business plan is to engage in a merger with an unidentified person; [4] The transaction does not relate to an unsold allotment to, or a subscription or participation by, a broker or dealer as an underwriter of the securities; [5] The securities have been authorized and outstanding for at least 90 days; and [6] If the issuer of the securities is not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, a variety of specified information must be provided to prospective purchasers, including the issuer's most recent balance sheet and statement of profit and loss and similar financial statements for the two preceding fiscal years, prepared in accordance with U.S. GAAP or, in the case of a foreign private issuer, International Financial Reporting Standards ('IFRS').").

would increase the number of potential participants in, and thus the liquidity of, the secondary market.

C. *Other Situations*

The AI definition also impacts other aspects of federal and state securities laws. For example, it is part of the threshold that determines when companies must register under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act").[60] Even if a company carefully raises funds pursuant to exempt offerings, and thereby avoids a costly registration under the Securities Act, it will have to register under the Exchange Act once certain thresholds are exceeded. More specifically, most types of issuers are required to register securities under the Exchange Act, if the company has more than $10 million of total assets and the securities are "held of record" by either 2,000 persons or 500 persons who are not AIs.[61] Thus, a company with over $10 million in total assets and a capitalization table showing only 499 non-AIs holding shares of stock could issue additional shares to up to 1,500 new stockholders, without triggering an Exchange Act registration and its associated costs,[62] provided the new stockholders are all AIs.[63]

By way of further example, several state securities laws and regulations already piggyback off the SEC's AI definition. For instance, the North American Securities Administrators Association's (NASAA's) Model Accredited Investor Exemption, which was adopted in 1997, exempts securities from state registration requirements. However, the model exemption requires, among other things, that the securities are sold only to AIs.[64]

Thus, changes to the (Federal/SEC's) AI definition will also automatically impact issuers and investors at the state level, to the extent they are subject to those state laws and regulations.[65]

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60. *See* 17 C.F.R. § 240.12g-1.

61. *See id*. However, in the case of a bank, a savings and loan holding company, or bank holding company, the company is not required to register until it has more than $10 million of total assets and its securities are held of record by 2,000 or more persons (regardless of whether they are AIs or non-AIs). *Id*.

62. PWC DEALS, *supra* note 7 and accompanying text.

63. Also, securities issued pursuant to Regulation Crowdfunding are conditionally exempted from the stockholder count, for purposes of Section 12(g), if the company has total assets of $25 million or less and certain other conditions are satisfied. *See* 17 C.F.R. § 240.12g-6.

64. *See* Commission Notice: Annual Conference on Uniformity of Securities Laws, U.S. SEC. & EXCH. COMM'N (March 10, 2000), https://www.sec.gov/rules/other/33-7808.htm (Per Section III(A)(2) and footnote 10 thereto, "[t]he term 'accredited investor,' [is] as defined by the Securities Act and the Commission's rules under the Act.").

65. That is, to the extent state laws and regulations already provide exemptions (or other favorable treatment) when AIs are involved, no state action would be required to have an impact at the state level since state laws and regulations simply utilize the AI definition of the federal government and the SEC.

III. CALLS TO EXPAND THE ACCREDITED INVESTOR DEFINITION

Because of both the shortcomings and importance of the current AI definition, several individuals and organizations have called to expand it by adding criteria other than one's income and net worth. This Part III provides examples of initiatives to expand the AI definition and summarizes some of the proposals for *how* this might be done.

A. *SEC-Related Initiatives*

On August 13, 2019, an SEC director announced that updating the AI definition is a "top priority," given its important role in shaping the market for private placements.[66] This should not be a surprise. The 2018 SEC Government-Business Forum on Small Business Capital Formation made expanding the AI definition the number one priority in its Consolidated Forum Recommendations (SEC Forum Recommendations).[67] This should not have been a shocker either since earlier SEC Forum Recommendations also made expanding the AI definition the number one priority in 2015,[68] 2016,[69] and 2017.[70] Moreover, in its 2015 Report on the Review of the Definition of "Accredited Investor," SEC staff recommended the Commission "revise the accredited investor definition to allow individuals to qualify as accredited investors based on other measures of sophistication."[71] Further, the SEC Advisory Committee on Small and Emerging Markets, which morphed into the Small Business Capital Formation Advisory Committee, has repeatedly recommended the SEC expand the pool of AIs (SEC AC Recommendations).[72] While the opportunity to expand the AI defini-

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66. *See* Zanki, *supra* note 4 ("Bill Hinman, director of the SEC's Division of Corporation Finance, said updating the definition of an 'accredited investor' is a top priority . . . .").

67. *See* U.S. SEC. & EXCH. COMM'N, 2018 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION: FINAL REPORT 17 (June 2019), https://www.sec.gov/info/smallbus/gbfor37.pdf (showing expansion of the definition of AI ranked first of ten priorities).

68. *See* U.S. SEC. & EXCH. COMM'N, 2015 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION: FINAL REPORT 23 (Apr. 2018), https://www.sec.gov/info/smallbus/gbfor34.pdf (showing expansion of the definition of AI ranked first of fourteen priorities).

69. *See* U.S. SEC. & EXCH. COMM'N, 2016 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION: FINAL REPORT 16 (Mar. 2017), https://www.sec.gov/info/smallbus/gbfor35.pdf (showing expansion of the definition of AI ranked first of fifteen priorities).

70. *See* U.S. SEC. & EXCH. COMM'N, 2017 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION: FINAL REPORT 17 (Mar. 2018), https://www.sec.gov/info/smallbus/gbfor36.pdf (showing expansion of the definition of AI ranked first of twenty priorities).

71. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 7 (2015), https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf [hereinafter REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR"].

72. *See* Posner, *supra* note 12 ("In 2015 and 2016, the SEC Committee on Small and Emerging Companies (which then morphed into the Small Business Capital Formation Advisory Committee), urged the SEC to 'do no harm' with regard to the accredited investor definition. . .[t]he committee expressed its support for 'expanding the definition to take into account measures of sophistication, regardless of income or net worth, thereby expanding rather than contracting the pool

tion has clearly been brought to the SEC's attention over the years (even by its own staff, committees, and leadership),[73] rules defining an AI have been largely untouched since 1982.[74]

B. *Fair Investment Opportunities for Professional Experts Act*

As one practitioner points out, the Fair Investment Opportunities for Professional Experts Act reflects the House of Representatives' (House's) impatience with the SEC's failure to revise the AI definition to increase the potential pool of investors for the private placement market.[75] In short, the House bill (H.R. 2187) would have directed the SEC to revise its own regulations regarding the AI definition.[76] On February 1, 2016, the House passed H.R. 2187 by a vote of 347 to 8.[77] After dying in the Senate,[78] H.R. 2187 was reborn as H.R. 1585 (which was also named the Fair Investment Opportunities for Professional Experts Act) and approved by the House on November 1, 2017.[79] However, like

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of accredited investors.'"); *see also* U.S. Sec. & Exch. Comm'n, *supra* note 9 (recommending expansion of the AI definition via recommendations #1 through #4); Recommendations Regarding the Accredited Investor Definition, U.S. Sec. & Exch. Comm'n (Mar. 9, 2015), https://www.sec.gov/info/smallbus/acsec/acsec-accredited-investor-definition-recommendation-030415.pdf (recommending expansion of the AI definition via recommendation #1); U.S. Sec. & Exch. Comm'n, Final Report of the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies (Sept. 2017), https://www.sec.gov/info/smallbus/acsec/acsec-final-report-2017-09.pdf (supporting expansion of the AI definition on page 12) [hereinafter Final Report of SEC Advisory Committee].

73. *See, e.g.*, *supra* notes 67–72; *see also,* H.R. REP. NO. 115-375 at 4 (Oct. 31, 2017) ("At an October 4, 2017 Financial Services Committee hearing, SEC Chairman Jay Clayton agreed that the definition of accredited investor should be reconsidered and testified that he did not care for the binary nature of the current definition. Expanding the accredited investor definition not only benefits the companies raising funds but also provides investors with more attractive investment opportunities. As SEC Commissioner Michael Piwowar has astutely observed, allowing retail investors to invest in both public and private companies can actually have the effect of reducing risk in their overall portfolio.").

74. *See* Zanki, *supra* note 4 ("Current rules defining an accredited investor are based strictly on wealth and have been largely untouched since 1982.").

75. *See* Park S. Bramhall, *House Passes Bill to Expand Accredited Investor Definition,* LOWENSTEIN SANDLER LLP (Feb. 2016), https://www.lowenstein.com/media/3208/house-passes-bill-to-expand-accredited-investor-definition.pdf ("As indicated in the debate that immediately preceded the adoption of HR 2187 and the report of the House's Financial Services Committee that accompanied it . . . HR 2187 reflects both the House's impatience with the SEC's failure to revise the accredited investor definition to increase the potential pool of investors for the private placement market and its desire to prevent the SEC from imposing any restrictions that would have the opposite effect.").

76. *See* Fair Investment Opportunities for Professional Experts Act, H.R. 2187, 114th Cong. (2015), https://www.govtrack.us/congress/bills/114/hr2187.

77. *Id.*

78. *Id.*

79. *See* Fair Investment Opportunities for Professional Experts Act, H.R. 1585, 115th Cong. (2017), https://www.govtrack.us/congress/bills/115/hr1585.

its predecessor H.R. 2187, H.R. 1585 was never passed by the Senate.[80] While action by Congress could have brought about change, the SEC already has the authority to expand the AI definition.[81]

C. *Other Calls for Expansion*

Many others have also demonstrated support for expanding the AI definition. For example, in October 2017, the U.S. Department of the Treasury published a report recommending, among other things, expanding the pool of AIs.[82] Further, in response to its 2015 staff report, the SEC received several comment letters from industry groups, academia, and others showing support for various ways of expanding the AI definition.[83]

D. *Suggestions for How to Expand the Accredited Investor Definition*

When making calls to expand the AI definition, some of the above referenced commentators also suggested *how* to do so. Proposals included adding the following types of natural persons to the AI pool:

- Individuals who have certain educational backgrounds;[84]
- Individuals who have certain business experiences and professional credentials/certifications;[85]
- Individuals who invest minimum amounts;[86]
- Individuals who have experience investing in exempt offerings;[87]

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80. *Id*.

81. *See* 15 U.S.C. 77b(a)(15)(ii) (2012) (noting that AIs shall include "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.")

82. U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 44 (2017) ("Treasury recommends that amendments to the accredited investor definition be undertaken with the objective of expanding the eligible pool of sophisticated investors.") [hereinafter A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS].

83. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,473–77.

84. *See, e.g.*, Fair Investment Opportunities for Professional Experts Act, H.R. 1585, 115th Cong. (2017) (empowering the SEC to determine what constitutes suitable education, while also requiring verification of one's education by FINRA or an equivalent self-regulatory organization); U.S. SEC. & EXCH. COMM'N, *supra* note 71, at 58.

85. *See, e.g.*, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 8, 58–61, 94–95. H.R. 1585 would add (i) natural persons who are "currently licensed or registered as a broker or investment adviser by the [SEC], [FINRA], or an equivalent self-regulatory organization . . . or the securities division of a State" and (ii) more natural persons the SEC determines to have suitable experience provided such experience is "verified by [FINRA] or an equivalent self-regulatory organization." *See* H.R. 1585, 115th Cong. (2017).

86. REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 8, 94.

87. *Id.* at 8, 62–64, 95.

- Individuals who are knowledgeable employees of issuers or private funds;[88]
- Individuals who are advised by professionals;[89]
- Individuals who stay within investment limits;[90] and
- Individuals who pass an AI examination.[91]

Commentators also noted the importance of simplicity and being able to ascertain any criteria with certainty (i.e., having bright line tests as opposed to using a principles-based approach when making AI or non-AI determinations).[92] While many of these proposals show promise, the author believes the AI exam is the superior approach for at least five reasons:

1. It could be tailored to assess appropriate topics (and thus more relevant than credentials or certifications demonstrating knowledge of traditional accounting topics or finance theories, for instance);
2. It could educate investors on best practices and thus encourage smarter deals;
3. It could provide certainty to issuers and others (i.e., one must pass the AI exam);
4. It could assess whether individuals with education and/or experience are truly experts; and
5. It could be linked to other criteria—e.g., utilizing investment limits and considering exempt offering experience.

IV. THE ACCREDITED INVESTOR EXAM

This Part IV looks more closely at what an AI exam might look like. First, several examinations suggested by the above initiatives are noted and, for three of the items, particular exam topics are summarized. Second, characteristics and practices of VCs are considered. Third, the author suggests the AI exam should not expect test takers to have all of the answers themselves. Instead, it should enable test takers to spot areas where knowledge gaps and other risks are likely to exist and empower them to seek help to mitigate some of those risks and consider the others. Finally, this Part IV explores the idea of linking the AI exam to investment limits and/or relevant experience.

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88. *Id.* at 8, 64–65, 95–96.

89. *Id.* at 61–62; *see also* A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS, *supra* note 82, at 44.

90. *See, e.g.*, Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,475.

91. REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 8, 65–67, 96.

92. *See, e.g.*, Final Report of SEC Advisory Committee, *supra* note 72, at 12.

A. *Summary of Existing Exam-Focused Proposals*

Several proposals have been made that relate to a potential AI exam. Instead of referencing specific examinations, some proposals require one to become a licensed professional that would first require the individual to pass an exam (or exams) and possibly complete additional steps.[93] These licensed professionals include: brokers or investment advisors licensed by the SEC, FINRA (or an equivalent self-regulatory organization), or a state securities division;[94] Certified Financial Analysts (CFAs), Certified Public Accountants (CPAs), and Certified Financial Planners (CFPs);[95] Certified Managerial Accountants (CMAs);[96] and attorneys.[97] Other proposals reference specific tests, including the Series 7, Series 65, and Series 82 examination.[98] However, it is unclear whether/how any non-exam requirements typically coupled with these exams would be waived.[99] To provide concrete examples of potential test subjects, Part IV.A looks at exam criteria referenced in the first draft of the Fair Investment Opportunities for Professional Experts Act. It then looks more closely at two exams called out as potential models for an AI exam in the SEC Staff Report: FINRA's Series 7 and Series 82 examinations.[100]

1. Initial Draft of Fair Investment Opportunities for Professional Experts Act

Specific exam topics were listed out in the first version of H.R. 2178 (which, again, became H.R. 1585).[101] The initial draft of H.R. 2178 directed the SEC to establish criteria for FINRA to use in administering an exam to license

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93. For example, some professions will require exam takers to also work for a period of time and/or be associated with other professionals who already hold the applicable license.

94. *See* H.R. 1585, 115th Cong. (2017) at 3–4.

95. *See, e.g.*, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 59–60.

96. *See, e.g.*, Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1, at 30,475.

97. *See id.*

98. *See, e.g.*, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 95.

99. For example, exam candidates must be associated with and sponsored by a FINRA member firm, or other applicable self-regulatory organization member firm, to be eligible to take FINRA exams. *See* FINRA, *Series 7 – General Securities Representative Exam*, https://www.finra.org/industry/series7 (last visited Sept. 5, 2019). By way of further example, candidates who take the Series 7 Examination must also pass the Securities Industry Essentials (SIE) exam to obtain the General Securities Representative registration. *See id.*

100. *See, e.g.*, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR," *supra* note 71, at 96.

101. Fair Investment Opportunities for Professional Experts Act, H.R. 2187, 114th Cong. § 3 (2015), https://www.congress.gov/114/bills/hr2187/BILLS-114hr2187ih.pdf (the initial version of H.R. 2187 as introduced to the House on Apr. 30, 2015).

natural persons not already meeting the AI's Net Worth or Income Thresholds.[102] More specifically, it stated:

> Such criteria may include methods for assuring that licensed accredited investors demonstrate a competency in understanding the following:
>
> (1) The different types of securities.
>
> (2) The disclosure obligations under the securities laws of issuers versus private companies [sic].
>
> (3) The structures of corporate governance.
>
> (4) The components of a financial statement.
>
> (5) Other criteria the Commission shall establish in the public interest and for the protection of investors.[103]

While the above text was not included in the version of the H.R. 2178 that passed the House by a vote of 347 to 8 on February 1, 2016,[104] it provides insights into topics an AI exam might cover.[105]

2. FINRA's Series 82 Examination

The Series 82 exam, named the Private Securities Offerings Representative Qualification Examination, assesses the competency of entry-level registered representatives to perform their job as private securities offerings representatives.[106] A candidate who passes the Series 82 exam is deemed qualified for the solicitation and sale of private placement securities products as part of a primary offering.[107] As its name suggests, the exam tests knowledge in several areas relevant to exempt offerings, including:

- Private offerings exemptions from registration and classes of securities;
- Feasibility studies and due diligence (e.g., the components of due diligence: financial, industry and operational data, management and employee relations, research, product development and expansion);
- Special issues dealing with electronic offerings;
- Pricing offerings;

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102. *Id.*

103. *Id.*

104. *See* Fair Investment Opportunities for Professional Experts Act, H.R. 2187, 114th Cong. (2016), https://www.congress.gov/114/bills/hr2187/BILLS-114hr2187eh.pdf (the engrossed version of the bill as passed by the House on Feb. 1, 2016); *Actions Overview H.R.2187—114th Congress (2015–2016)*, CONGRESS.GOV, https://www.congress.gov/bill/114th-congress/housebill/2187/actions.

105. While H.R. 2187 eventually died in Congress, it was reintroduced (and again approved by the House) on Nov. 1, 2017 as H.R. 1585. However, like H.R. 2187, H.R. 1585 did not obtain Senate approval. *See supra* Part III.B.

106. FINRA, *Series 82 – Private Securities Offerings Representative Exam*, https://www.finra.org/industry/series82 (last visited Sept. 5, 2019) [hereinafter FINRA, *Series 82*].

107. *Id.*

- Regulation A offerings;
- Financial factors relevant to assessing investment profile (e.g., security holdings, other assets and liabilities, annual income, net worth, tax considerations, home ownership and financing, employee stock options, insurance, liquidity needs);
- Tax consequences of securities transactions (e.g., holding period, basis, dividends, interest income);
- Verification of investor accreditation and sophistication;
- Ability to understand risks of the underlying investment;
- Equity and debt instruments in the context of private placements;
- Concentration of investment in a small number of issues versus diversification;
- Convertibility of securities (including the value of the conversion feature and the effect of potential forced conversion);
- Transaction disclosure requirements; and
- Methods of formal resolution (e.g., arbitration, mediation, litigation).[108]

The Series 82 exam consists of 50 multiple choice items and candidates have 90 minutes to complete it.[109] They must take the exam at one of many Prometric test centers.[110] In order to pass, candidates must score at least 70%.[111] It costs $40 to sit for the exam.[112]

3. FINRA's Series 7 Examination

The Series 7 exam, named the General Securities Representative Qualification Examination, assesses the competency of entry-level registered representatives to perform their job as general securities representatives.[113] A candidate who passes the Series 7 exam is deemed qualified for the solicitation, purchase and/or sale of all securities products.[114] Despite its more general coverage, the

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108. FINRA, *Private Securities Offerings Representative Qualification Examination (Series 82) – Content Outline,* https://www.finra.org/sites/default/files/Series_82_Content_Outline.pdf (last visited Sept. 5, 2019).

109. *See* FINRA, *Series 82*, *supra* note 106.

110. *Schedule an Exam*, FINRA, https://www.finra.org/industry/schedule-exam. Per its website, Prometric operates a network of 8,000 test centers in more than 160 countries and offers a wide selection of times and dates for testing. *See About Prometric*, PROMETRIC, https://www.prometric.com/about-us/about-prometric (last visited Sept. 5, 2019).

111. *See* FINRA, *Series 82*, *supra* note 106.

112. *Id.*

113. *See supra* note 99.

114. *Id*.

Series 7 exam tests knowledge in several areas relevant to exempt offerings, including:[115]

- Requirements for initial public offerings, Regulation A offerings, Regulation D offerings, and other exempt securities and transactions;
- Regulatory requirements for resales;
- Financial factors relevant to assessing investment profile (e.g., security holdings, other assets and liabilities, annual income, net worth, tax considerations, home ownership and financing, employee stock options, insurance, liquidity needs);
- Fundamental analysis of financial statements and types of financial statements included in an annual report, importance of footnotes, material risk disclosures, and key terms;
- Types of stock (e.g., authorized, issued, outstanding, Treasury stock, stated value);
- Characteristics and rights of common stock and preferred stock;
- Warrants and options;
- Tax treatment of securities transactions (e.g., capital gains and losses, dividend distributions, holding periods, determination of net long-term and short-term gains or losses);
- Types of debt securities; and
- Investment companies.

The Series 7 exam consists of 125 multiple choice items and candidates have 225 minutes to complete it.[116] They take the exam at one of many Prometric test centers.[117] In order to pass, candidates must score at least 72%.[118] It costs $245 to sit for the exam.[119]

B. *How Venture Capitalists Invest*

Not all exempt offerings will be structured the same way. However, if we assumed that all issuers participating in exempt offerings were VC-backed companies, business organizations and financings would resemble each other. This is because a VC-backed company is likely to use:

- The Delaware corporation entity form;[120]

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115. *See* FINRA, *General Securities Representative Qualification Examination (Series 7) – Content Outline*, https://www.finra.org/sites/default/files/Series_7_Content_Outline.pdf (last visited Sept. 5, 2019).

116. *See supra* note 99.

117. *See Schedule an Exam*, FINRA, https://www.finra.org/industry/schedule-exam (last visited Sept. 5, 2019).

118. *See supra* note 99.

119. *Id.*

120. *See, e.g.*, BRAD FELD & JASON MENDELSON, VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST 207 (3d ed. 2016) ("If you are going to raise VC or angel money, a C Corp is the best (and often required) structure," concluding "we always encourage Delaware as the default case.").

- Two tiers of stock;[121]
- Standard seed financings structures and documents;[122]
- Standard VC deal terms and documents;[123] and
- Rule 506 exemptions.[124]

In fact, the standardization of deal structures, documents, and terms in the VC ecosystem has inspired the creation of some incredible resources, including:

- General and comprehensive summaries related to VC investing;[125]
- Entity formation-related documents;[126]
- Seed financing documents;[127]
- VC financing documents;[128]
- Document generators that create sets of formation and financing-related documents;[129]
- Deal term summaries and trends (e.g., with respect to valuations and frequency of specific deal terms);[130] and

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121. *See, e.g.*, CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, THE ENTREPRENEUR'S GUIDE TO LAW AND STRATEGY 96 (5th ed. 2018) ("Unlike the founders and other employees, venture capital investors usually acquire preferred, not common, stock."); *see also* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003).

122. *See, e.g.*, BAGLEY & DAUCHY, *supra* note 121, at 438 (stating "very early-stage financings (generally under $2 million) are often done through the issuance of convertible notes and, occasionally, SAFEs. A Simple Agreement for Future Equity (SAFE) is similar to a convertible note, but without a maturity date and interest."). These seed financings, which occur before venture capitalists invest in their initial (i.e., Series A) round, may include investors who are friends and family of the company's founders, accelerator programs, and angel investors. Series Seed stock is another structure used for seed financings. *See id*. at 455 ("Increasingly, companies are choosing to start with a 'Series Seed Preferred Stock' (also called 'Seed Series') round before the 'A' round.").

123. *See, e.g.*, FELD & MENDELSON, *supra* note 120, at 2 ("[D]efinitive documents have become more standard over time. Whether it is the Internet age that has spread information across the ecosystem or clients growing tired of paying legal bills, there are more similarities in the documents today than ever before. As a result, we can lend you our experience in how venture financings are usually done.").

124. *See supra* Part II.A.

125. *See, e.g.*, FELD & MENDELSON, *supra* note 122; *see also*, COOLEY GO, https://www.cooleygo.com/.

126. *See, e.g.*, STARTUP FORMS LIBRARY, http://www.orrick.com/Total-Access/Tool-Kit/Start-Up-Forms (last visited Sept. 4, 2019).

127. *See, e.g.*, *Series Seed Convertible Note Financing Package*, COOLEY GO, https://www.cooleygo.com/documents/series-seed-notes-financing-package/ (last visited Sept. 4, 2019); *see also* Carolynn Levy, *Safe Financing Documents*, Y COMBINATOR (Sept. 2018), https://www.ycombinator.com/documents/; SERIES SEED, https://www.seriesseed.com/ (last visited Sept. 4, 2019).

128. *See, e.g.*, *Model Legal Documents*, NVCA, http://www.nvca.org/resources/model-legal-documents/ (last visited Jan. 19, 2020).

129. *See, e.g.*, *Index of Cooley Go Docs Document Generators*, COOLEY GO, https://www.cooleygo.com/documents/index-document-generators/ (last visited Sept. 4, 2019).

130. *See*, *e.g.*, *Trends*, COOLEY GO, https://www.cooleygo.com/trends/ (last visited Sept. 4, 2019).

- Comprehensive platforms that help with human resource, equity management, fundraising, and corporate governance needs.[131]

These standards and resources make for excellent teaching and testing materials for students and practitioners.[132] However, as inferred from the list of standards and resources, the pertinent issues differ from those studied in traditional finance courses[133] and are, in many ways, law heavy.[134]

Yes, it is inaccurate to assume all companies will be VC-backed. However, if exempt offering investment experience is truly valuable, the AI exam should cover what VCs do.[135] They are the professionals in the exempt offering space. Moreover, they act differently than investors in more established firms. Not only do they utilize standard structures, documents, and terms, they have unique approaches when selecting investments.[136] Among other things, they rely more heavily on qualitative factors and less heavily on things like cash flow analysis.[137]

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131. *See, e.g.*, SHOOBX, https://www.shoobx.com (last visited Sept. 4, 2019).

132. While this Part IV.B focuses on VC investments in startups and other high-growth ventures, exempt offerings will also include investment funds. For example, AIs will invest in angel funds, VC funds, other private equity funds, and even hedge funds. *See, e.g.*, Finger, *supra* note 10, at 734. Similar to the VC-backed companies covered in Part IV.B, these funds have standard deal structures, documents and terms. For example, the process usually involves: (i) an offering document, (ii) a Delaware limited partnership agreement, (iii) a subscription agreement, and (iv) an investor questionnaire – and similar background laws. *See Fundamentals of Private Equity Fund Formation*, MORGAN, LEWIS & BOCKIUS LLP, https://www.morganlewis.com/-/media/files/special-topics/vcpefdeskbook/appendices/vcpefdeskbook_appendix-fundamentalsoffundformation.ashx. Further, these funds utilize similar fee structures whereby the fund charges an annual management fee (e.g., 2.5%) on the committed capital amount as well as a carry, which is a share (e.g., 20%) of the fund's profits.

133. *See, e.g.*, Paul A. Gompers et al., *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 169, 170–71 (2020) ("The paucity of historical operating information and the uncertainty of future cash flows makes VCs' investment decisions difficult and less like those in the typical setting taught in MBA finance curricula.").

134. Thus, attorneys and legal educators are rightfully active in the VC education space. *See, e.g.*, *UC Berkeley and NVCA Launch VC University, A New Educational Program Providing Online and Live Events for the U.S. Entrepreneurial Ecosystem*, NVCA (Jan. 29, 2019), https://nvca.org/pressreleases/uc-berkeley-nvca-launch-vc-university-new-educational-program-providing-online-live-events-u-s-entrepreneurial-ecosystem/ ("The University of California, Berkeley, School of Law, through its Startup@BerkeleyLaw initiative, and the National Venture Capital Association (NVCA) are delighted to announce their partnership and launch of VC University, an educational program providing practical training on venture finance for entrepreneurs, investors, attorneys and others interested in emerging company finance.").

135. Regardless of whether an existing exam is used (or modified), or an entirely new exam is created, the AI exam should acknowledge unique aspects of early stage investing and focus on prevalent deal structures, documents, and terms.

136. *See* Gompers et al., *supra* note 133, at 180 ("Overall, VC firms as a class appear to make decisions in a way that is inconsistent with predictions and recommendations of finance theory. Not only do they adjust for idiosyncratic risk and neglect market risk, 23% of them use the same metric for all investments, even though it seems likely that different investments face different risks.").

137. *Id.* at 170–71 ("[I]n selecting investments, VCs place the greatest importance on the management/founding team. The management team was mentioned most frequently both as an im-

The NVCA's Series A Preferred Stock Purchase Agreement (NVCA's SPA) also sheds light on specific things VCs look for when making an investment.[138] Before putting their money into companies, VCs require the companies to make certain representations and warranties, which are facts and assurances about the business.[139] VCs can more easily bring a breach claim if the representations and warranties prove to be untrue. The NVCA's SPA has approximately 30 representations and warranties that address particular areas, including:[140]

- The company is in good standing and has the appropriate corporate powers;[141]
- The company's capitalization is as stated (e.g., the numbers of authorized, reserved and issued shares of stock, and options to acquire stock, are provided—as are the related vesting schedules and purchase prices);[142]
- The company is not involved in any lawsuit, arbitration, or similar action;[143]
- The company owns or possesses the intellectual property it needs to conduct its current and proposed business;[144]
- The financial statements delivered by the company were prepared in accordance with generally accepted accounting principles, and fairly present the financial condition and operating results of the company;[145] and
- The company employs the stated number of full-time and part-time employees.[146]

If these representations and warranties (or accompanying Disclosure Schedule) expose problems, VCs may (a) decide not to invest, (b) negotiate a lower valua-

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portant factor (by 95% of VC firms) and as the most important factor (by 47% of VC firms) . . . . [F]ew VCs use discounted cash flow or net present value (NPV) techniques to evaluate their investments.").

138. *See Stock Purchase Agreement*, NAT'L VENTURE CAP. ASS'N, http://www.nvca.org/resources/model-legal-documents/ (last visited Sept. 5, 2019).

139. *Id.* at 6, n.20 ("The purpose of the Company's representations is primarily to create a mechanism to ensure full disclosure about the Company's organization, financial condition and business to the investors. The Company is required to list any deviations from the representations on a Disclosure Schedule, the preparation and review of which drives the due diligence process on both sides of the deal . . . . Some practitioners prefer to deliver the Disclosure Schedule separately, instead of as an exhibit to the Stock Purchase Agreement, so that the Disclosure Schedule will not have to be publicly filed in the event the Stock Purchase Agreement is filed as an exhibit to a public offering registration statement.").

140. *Id.* at §§ 2.1–2.33.

141. *Id.* at § 2.1.

142. *Id.* at § 2.2.

143. *Id.* at § 2.7.

144. *Id.* at § 2.8.

145. *Id.* at § 2.14.

146. *Id.* at § 2.16.

tion, or (c) accept the risk. When making investments, VCs also insist their preferred stock receive special rights, when compared to the issuer's common stock. These special rights may include economic rights, control rights, and information rights.[147]

By encouraging individuals to think like VCs, the AI exam would not only help assess potential AIs, but would also educate non-VC investors and help develop a stronger exempt offering ecosystem. Stated differently, if VCs are the pros at investing in exempt offerings, others should benefit from learning what the VCs know and do – and they should either copy them or understand why and how their deals are different. For example, an individual contemplating an investment in a company that has no intentions of raising VC would still benefit from having an understanding of deal structures, documents, and terms commonly used in the VC ecosystem. For instance, while not all investors will be able to get companies to give them each of the representations and warranties in the NVCA's SPA, they should still know what questions to ask and make appropriate adjustments based on answers they receive (or fail to get).[148] Therefore, while all investors may not have a VC's leverage, much less the ability to protect against every risk, a strong AI exam should empower them to identify risks they might not otherwise spot – and this provides much value.

C. *Spotting and Dealing with Gaps*

The concept of using the AI exam to empower investors to spot risks, including risks that cannot be eliminated, should be expanded further. For example, the AI exam should not attempt to cover every applicable market in which investors might put their money (e.g., cannabis, artificial intelligence, financial services, software, biotechnology). Among other things, the AI exam would become too long. Instead, it should inform investors that it does not attempt to cover market-specific issues, and thus there will be gaps investors need to address (e.g., by independently learning about the market-specific issues and/or seeking out experts in the applicable area(s) for help). Similarly, the AI exam should not try to turn every investor into a tax or legal expert – but it should alert investors to pertinent issues and empower them to know when to seek out professional help and where to find it. The AI exam can also ensure investors comprehend common risk factors (including the risk of complete loss), liquidity challenges, and suggested investment limits associated with exempt offerings. Again, instead of trying to eliminate all applicable risks, the AI exam will prepare investors to spot risks, mitigate some risks (e.g., by learning more and/or seeking help), and deal with remaining risks (e.g., by adhering to reasonable investment limits).

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147. *See, e.g.*, FELD & MENDELSON, *supra* note 120, at 38, 87–88 (and generally).

148. Other tools can also help investors consider relevant issues and identify potential risks. *See, e.g.*, Form U7 (SCOR), North American Securities Adm'rs. Assoc. (May 19, 2019), https://www.nasaa.org/industry-resources/uniform-forms/.

D. *Linking the Exam to Investment Limits and Relevant Experience*

Even with a good AI exam, there is still concern that investors may not be able to bear the loss of their investments. That is, some people will invest (and eventually lose) too much. Some commentators argue that imposing investment limits is too parental and administratively difficult.[149] Others even take the position that consenting adults should simply be permitted to opt into AI status so long as they are warned about the risks.[150] While it seems appropriate to have some safeguards in place to protect investors from losing too much, perhaps it is proper to trust (and remind) people who pass the AI exam to not invest too much. More specifically, after they pass an exam that covers (among other things) the risks of complete loss and appropriate investment amounts, successful test takers could be required to certify they will not invest more than X% of the greater of their income or net worth in exempt offerings.[151] Moreover, these investors could be required to recertify their investment limit pledge each time they renew their AI license. Suggestions for an easily searchable central database (identifying individuals who passed the exam), license numbers, and renewal requirements (such as CPE) have previously been made.[152] The database and renewal procedures could also be used to report and audit exempt offering investments made by AI licensees, especially if self-certifications alone prove to be insufficient. Further, if exempt offering investment activity is being reported by AIs and the SEC desires to recognize or reward AIs for acquiring experience making these investments,[153] an AI's percentage limitation could increase (e.g., from X% to Y%) once the AI reports sufficient exempt offering experience.[154] The AI licensee database could also include individuals who are AIs because of the Net Wealth and/or Income Thresholds. Some current AIs do not want to share tax returns or similar information currently used to satisfy the AI safe harbor for Rule 506(c) offerings.[155] If a database and licensee number system is already established for AI exam takers, other (i.e., current) AIs could provide their information to just one party, get added to the database, and then use the licensee number when making investments; therefore protecting their private information. Given these enhancements and its relatively low initial and ongo-

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149. *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 1 at 30,475, 30,476 n.125.

150. In fact, the SEC is asking whether individuals should be able to opt into AI status, after receiving disclosures about risks. *See id*. at 30,469–78.

151. Whereby X could equal 10, for instance, to mirror limits on non-AIs under Tier 1 offerings under Regulation A. *See supra* Part II.A.

152. *See, e.g.*, Finger, *supra* note 10, at 762–63.

153. *Supra* note 87.

154. For instances, an investment limit of 10% (of the greater of income or net worth) could increase to 15% once an AI reports making 10 or more exempt offering investments of at least $1,000.

155. *See supra* note 33 and accompanying text.

ing disclosure requirements, Rule 506(c) could eliminate the need for Regulation A and/or Regulation CF.

CONCLUSION

New ventures move our economy. Most of these ventures need additional capital to grow. They raise this capital through exempt offerings, and exempt offerings are essentially limited by the pool of AIs. Natural persons must meet either the Net Worth Threshold or Income Threshold to be considered AIs. Because of this, AIs make up only 13% of U.S. households, and only a small fraction of these households actually invest in exempt offerings. There is consensus that it is time to consider criteria besides net worth and income. Expanding the AI population by welcoming people who pass a relevant exam is a responsible way to increase the number of AIs. Even if no other laws or rules change, the AI exam would help ensure investor protection while generating more investment alternatives for individuals, additional capital for new ventures, and increased liquidity for the market. For example, Rule 506(c) offerings already preempt state law. They also permit advertising, so long as all actual sales are to AIs. Rule 506(c) offerings are also less burdensome/costly than Regulation A and Regulation CF offerings. Thus, Rule 506(c) could provide a clean primary offering exemption that connects large crowds of new AIs (individuals who pass the AI exam) to businesses seeking capital. Further, secondary market liquidity would be improved under the existing Section 4(a)(7), since the AI exam would increase the number of purchasers eligible under the resale exemption. Like Rule 506(c), Section 4(a)(7) already preempts state law. Therefore, these two existing exemptions already provide a powerful primary-secondary combo ready to welcome individuals who pass the AI exam. So yes, simply taking the small step of redefining AI to include people who pass a relevant exam would be a giant leap for our economy. However, it may be time to aim higher – to shoot for the stars.

A few *additional* changes could transform the above primary-secondary combo into an even more harmonized framework of exemptions—one that is revolutionary. For example, the following two additional changes could inspire a cost-effective public offering alternative for companies and AIs: (i) allow advertising in connection with Section 4(a)(7) resales, so long as all resales are to AIs and (ii) exclude AIs from holder of record counts that might otherwise trigger registration under the Exchange Act. The first change should substantially increase liquidity for exempt securities and enable a robust secondary market. Moreover, making the first change seems reasonable, particularly since Rule 506(c) already allows advertising to everyone, so long as actual sales are only to AIs. Thus, the change would actually result in Section 4(a)(7) being more consistent with Rule 506(c). The second change would permit companies to stay private longer (perhaps forever); since they could, in theory, have an unlimited number of AIs (instead of having to register under the Exchange Act, and incur the associated costs, when they have either 2,000 persons or 500 persons who

are not AIs). While this would empower some companies to avoid going public altogether, investors who can fend for themselves would still have additional investment opportunities – and they can get in earlier (at a lower cost) and thus realize gains currently reserved for individuals meeting the Net Worth or Income Thresholds. Just changing the AI definition has proven to be challenging. Thus, perhaps making that change alone should be the initial goal. However, if we could put a man on the moon 50 years ago, we should now be able to make a few additional changes to create a harmonized framework of exemptions—a framework that creates even more investment options, even more capital for new ventures, and even more of an economic impact.