Utah Law Review

Volume 2014 | Number 2 Article 4

2014

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THE BAN HAS LIFTED: NOW IS THE TIME TO CHANGE THE ACCREDITED-INVESTOR STANDARD

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I. INTRODUCTION

In July 2013, the United States Securities and Exchange Commission lifted an eighty-year ban on general solicitation and general advertising for certain private securities offerings.[1] This was part of a mandate from the Jumpstart Our Business Startups Act[2] (JOBS Act) in an effort to help small and emerging companies grow. Before, private companies had to rely on private connections or hire an investment bank with those connections in order to raise capital. Now, these companies may solicit or advertise securities through the mail, phone, and Internet, but only when they are selling to accredited investors. This new rule does not replace the old rule, which allowed a portion of the investors to be unaccredited. Rather, the new rule adds to the old rule.

The problem with the current accredited-investor standard is that it considers only wealth in determining whether a person may invest. These exempted securities are typically high risk, and because the standard does not take into account investor sophistication or cap the investment amount, it is possible for unsophisticated, inexperienced investors to lose everything on one bad investment. Lifting the general advertising ban creates a risk of financial harm and fraud by allowing issuers to target unsophisticated investors who need protection, including the elderly.

To ameliorate these potential harms, this Note proposes a new accredited-investor standard involving a mixture of wealth, financial sophistication, and diversification considerations. Additionally, companies should be required to disclose certain information, including the amount of risk and the fact that the securities are unregistered, *before* they solicit or sell their securities. Finally, investors should not be allowed to invest all of their income or net worth into one investment; rather, investors should only be allowed to invest a certain percentage

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[1] *See* Press Release, SEC Approves JOBS Act Requirement to Lift General Solicitation Ban (July 10, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782#.UmRxVxbnXCE.

[2] Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

to ensure that if the securities fail or are fraudulent, investors will not lose all of their wealth at once.

Part II of this Note explores the history and purpose of the advertising ban. Part III explains the problems with the advertising ban and its effect on emerging companies. Part IV discusses the JOBS Act and the circumstances leading up to the removal of the ban. Parts V and VI explore the implications of the ban's removal for companies and investors, respectively. Part VII highlights the issues of the accredited-investor standard and outlines a model for a new standard.

II. BACKGROUND

At the height of the Great Depression, President Franklin D. Roosevelt took office with an ambitious plan to regulate the banking industry.[3] This plan led to the creation of the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC).[4] Additionally, Congress passed the first federal legislation regulating securities, known as the Securities Act of 1933 ("Act").[5]

The purpose of the Act is to ensure investors have the information they need to make an informed decision regarding the purchase of securities and to prohibit fraud and other misrepresentations in connection with the offer or sale of securities.[6] Congress charged the SEC with accomplishing these goals.[7] The SEC, therefore, requires "issuers" of stock—individuals or businesses wishing to offer or sell stock—to register their securities and make a number of disclosures.[8] The Act's registration requirement extends to all offers or sales of securities unless an exemption applies. Regulation D of the Act lays out several registration exemptions for private offerings, found in Rules 504, 505, and 506.[9] These

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[3] *See, e.g.*, *New Deal Achievements*, FRANKLIN D. ROOSEVELT AM. HERITAGE CTR. MUSEUM, http://www.fdrheritage.org/new_deal.htm (last visited Apr. 5, 2014) (covering several of the finance-related reform initiatives President Roosevelt signed into law during the early days of the New Deal, including the Emergency Banking Act and the creation of the FDIC and SEC).

[4] *Id.*

[5] 15 U.S.C. §§ 77a–77r (2012).

[6] *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml (last visited Apr. 5, 2014).

[7] *See generally* 15 U.S.C. §§ 77a–77r.

[8] *Id*. § 77e(a)–(c).

[9] *See* 15 U.S.C. § 77d; 17 C.F.R. § 230.504–.506 (2012). Rule 504 allows a company to offer unregistered securities worth up to $1 million to an unlimited number of investors in any twelve-month period. 17 C.F.R. § 230.504. Rule 505 allows a company to offer unregistered securities worth up to $5 million to an unlimited number of accredited investors and up to thirty-five unaccredited investors in any twelve-month period. *See id.* §§ 230.501(e)(1)(iv), 230.505(b)(2)(ii). In 1996, Congress passed the National Securities Markets Improvement Act (NSMIA) that preempted state registration requirements for offerings that were exempt under federal law. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended at 15 U.S.C. § 77r (2012)); *see also* William K. Sjostrom, Jr.,

exemptions include the prohibition on general advertising and solicitation. The JOBS Act, however, only affected Rule 506 by removing the ban on general advertising and solicitation.[10]

A. Rule 506 Before the JOBS Act

Rule 506 is considered a "safe harbor" exemption: it allows private companies to raise an unlimited amount of capital without having to register the securities.[11] This exemption is subject to several restrictions. Importantly, the securities must be sold to accredited investors.[12] Accredited investors are those whose net worth exceeds $1 million excluding the value of a primary residence or those whose annual income exceeded $200,000 in the past two years, with the expectation that the income will increase or stay the same in the current year.[13] Prior to the JOBS Act, Rule 506 allowed a company to sell securities to up to thirty-five non-accredited investors so long as the investors are "sophisticated."[14] Sophisticated investors are those who have "sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment."[15]

While companies are saved from the time and expense of registering, they must still complete a Form D after the securities are sold.[16] Additionally, the securities sold under this exemption are "restricted," meaning they may not be resold within one year unless registered.[17] Finally, the rule banned general advertising and general solicitation.[18]

Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings, 32 FLA. ST. U. L. REV. 1, 43–44 (2004).

[10] Congress also lifted the general advertising ban placed on Rule 144A regarding the resale of securities. 15 U.S.C. § 77d. Rule 144A is not part of Regulation D and deals with "qualified institutional buyers," not accredited investors, and is, therefore, beyond the scope of this Note.

[11] *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/rule506.htm (last visited Apr. 5, 2014).

[12] *Id.*

[13] *Fact Sheet: Eliminating the Prohibition on General Solicitation and General Advertising in Certain Offerings*, U.S. SEC. & EXCH. COMM'N (July 10, 2013), http://www.sec.gov/news/press/2013/2013-124-item1.htm.

[14] *Rule 506 of Regulation D, supra* note 11.

[15] *Id.*

[16] 17 C.F.R. § 239.500 (2012).

[17] *Rule 506 of Regulation D, supra* note 11.

[18] 17 C.F.R. § 230.502(c).

B. Definition of General Advertising

Rule 502(c) of Regulation D contains the limitations on general advertising and general solicitation.[19] While neither term is actually defined in the statute, it does offer the following examples:

> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.[20]

These examples clarify the means of general advertising—newspaper, magazine, television ads—but not the method or conduct that actually constitutes general advertising. Is it the *number* of persons solicited or the *type* of persons solicited? As it turns out, it could be either. It depends on the facts and circumstances of the individual case.[21] The SEC's main focus is on the *relationship* between the issuer and the investor.[22] Where the issuer has a preexisting relationship with the investor, it is unlikely that a general solicitation has occurred.[23]

Courts have also found that the preexisting-relationship standard may allow a company to claim an exemption because "if there is some special, close relationship between the offerees and the issuer, then there may be access to the sort of information that registration would disclose."[24] Put differently, if there is a preexisting relationship between the issuer and the investor, it is likely the investor knows enough about the investment to make an informed decision. And an investor who makes an informed decision is less likely to fall victim to fraud.

If a business personally lacks the preexisting relationships necessary to obtain funding, it is not completely out of luck. Any existing clients of an investment bank are considered preexisting relationships for purposes of satisfying Rule 506.[25] These banks can "rent their preexisting, substantive relationships to companies

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[19] *Id.*

[20] *Id.*

[21] *See* Interpretive Release on Regulation D, 48 Fed. Reg. 10,045, 10,049 (Mar. 3, 1983).

[22] *See id.*

[23] *See* Woodtrails—Seattle, Ltd., SEC No-Action Letter, [1982–1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,342 (Aug. 9, 1982), *available at* 1982 WL 29366.

[24] Mark v. FSC Sec. Corp., 870 F.2d 331, 334 (6th Cir. 1989) (citing SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953)).

[25] *See, e.g.*, Bateman Eichler, Hill Richards, Inc., SEC No-Action Letter, 1985 WL 55679 (Dec. 3, 1985); H. B. Shaine & Co., Inc., SEC No-Action Letter, 1987 WL 107907 (May 1, 1987).

seeking private equity."[26] The bank will typically charge a commission of up to 10% of the offering.[27] Many times these banks will also take a grant of common stock in the company.[28]

III. PROBLEMS WITH THE BAN: HARM TO EMERGING COMPANIES

The general advertising ban was felt most deeply on new and emerging ventures.[29] Well-established companies either were able to afford the time and expense of going public[30] or had the connections through preexisting relationships or investment banks to privately sell securities.[31] President Barack Obama said at the signing of the JOBS Act:

> [B]ecause we're still recovering from one of the worst recessions in our history, the last few years have been pretty tough on entrepreneurs. Credit's been tight, and no matter how good their ideas are, if an entrepreneur can't get a loan from a bank or backing from investors, it's almost impossible to get their businesses off the ground.[32]

Although the general solicitation ban initially helped in reducing fraud at the time of its passage in 1933, the ban ultimately "had unintended consequences that hurt honest everyday small business owners and entrepreneurs, restricting them in their efforts to attract potential investors and critical seed and growth capital."[33] Even the SEC noted that the ban on general advertising "hampers the utility of the exemption and may raise the costs to companies of trying to do these exempt

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[26] Sjostrom, Jr., *supra* note 9, at 15.

[27] *Id.*

[28] *Id.*

[29] *Id.* at 14 (arguing that new ventures "must either (1) have preexisting relationships with a large number of accredited investors or (2) know or hire someone who does. Otherwise, an emerging company is left with the very difficult task of attracting buyers to a product, that is, its securities, without advertising").

[30] *See* Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1, 7–10 (2007) ("For most small businesses, the decision whether to 'go public' is, realistically, more theoretical than anything else.").

[31] *See id.* at 6 ("[I]t is easier for a medium-sized company to raise $50 million than for a small company to raise $500,000."); Sjostrom, Jr., *supra* note 9, at 3.

[32] Remarks on Signing the Jumpstart Our Business Startups Act, 2012 DAILY COMP. PRES. DOC. 1 (Apr. 5, 2012).

[33] Chance Barnett, *The Crowdfunder's Guide to General Solicitation and Title II of the JOBS Act*, FORBES (Sept. 23, 2013, 10:40 AM), http://www.forbes.com/sites/chancebarnett/2013/09/23/the-crowdfunders-guide-to-general-solicitation-title-ii-of-the-jobs-act/.

offerings."[34] In some cases, the costs were prohibitive and excluded companies from getting the funding they needed, resulting in the failure of many ventures.[35]

IV. LIFTING THE BAN: THE JOBS ACT AND SEC ADOPTION

A. JOBS Act of 2012

In late 2011, Congress began considering legislation aimed at ameliorating the plight of the small business. This was a particularly important focus at the time: strengthening small businesses would help boost the economy out of recession, as "nearly all net job creation in the United States occurred in firms less than five years old [from 1980–2005]."[36] As outlined above, new ventures are the most likely to benefit from the revocation of the general advertising ban. On the Senate floor, Senator John Tester stated:

> The role of startups in creating jobs and driving innovation has been well documented, but that ability to create jobs is limited if these firms do not have access to financing to scale and to grow their companies. So central to job creation is making sure investors and capital markets are accessible for startups.[37]

The bill moved quickly through the House and the Senate and passed both overwhelmingly "[i]n a rare moment of bipartisanship."[38] Title II of the JOBS Act, entitled Access to Capital for Job Creators, was signed into law in April 2012.[39] Under this Act, Congress required the SEC to revise Rule 506 "to provide that the prohibition against general solicitation or general advertising . . . shall not apply to offers and sales of securities made pursuant to [Rule 506]."[40] The Act also added

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[34] Exemption for Certain California Limited Issues, 60 Fed. Reg. 35,638, 35,641 (proposed July 10, 1995) (to be codified at 17 C.F.R. pt. 230) (discussing public comments on whether to eliminate the ban).

[35] Gregory C. Yadley, *General Solicitation: Looking for Funds in All the Wrong Places*, 70 FLA. B.J. 80, 82 (June 1996) ("Adequate investment capital is necessary to continuing American competitiveness in an increasingly global marketplace. Access to that capital by business, particularly small entrepreneurial businesses, is unduly hampered by current restrictions of the use of general solicitation and general advertising.").

[36] DANE STANGLER & ROBERT E. LITAN, WHERE WILL THE JOBS COME FROM? 2 (2009), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2009/11/where_will_the_jobs_come_from.pdf.

[37] 158 CONG. REC. S1885 (2012) (statement of Sen. John Tester).

[38] Jennifer Liberto, *House Passes Bipartisan Bill Aimed at Start-Ups*, CNN MONEY (Mar. 8, 2012, 3:24 PM), http://money.cnn.com/2012/03/08/smallbusiness/House-startup-bill/index.htm?hpt=hp_t1.

[39] Pub. L. No. 112-106, § 201, 126 Stat. 306, 313–15 (2012).

[40] *Id.* § 201(a)(1). In section 201(a)(2), Congress also lifted the general advertising ban placed on rule 144A regarding the resale of securities. This section does not deal with

section 4(b) to the Securities Act to clarify that securities sold under Rule 506 "shall not be deemed public offerings . . . as a result of general advertising or general solicitation."[41]

Congress then limited the scope of the ban removal by requiring that "all purchasers of the securities [be] accredited investors."[42] Before the Act, companies could sell securities under Rule 506 to up to thirty-five non-accredited, but sophisticated, investors.[43] Finally, the Act "require[s] the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."[44] With removing the ban on general advertising and general solicitation, along with the new restrictions on Rule 506, companies must ensure "diligence in ascertaining the accredited investor status of offerees in those offerings."[45]

At the signing of this bill, President Obama called the JOBS Act a "game changer," because it allows "startups and small business[es to] . . . have access to a big new pool of potential investors, namely, the American people."[46]

B. The SEC Lifts the Ban

In 2011, Meredith Cross, the Director of the Division of Corporation Finance of the SEC, spoke about the potential of lifting the ban on general solicitation. She said that before the ban is lifted,

> the staff wants to be confident that, if the ban is eliminated and private offerings are allowed through publicity and advertising, the group to whom the securities are sold is the group that does not need the protection of the federal securities laws and that they are, in fact, accredited investors. If they do not need protection, it may make sense to make it easier to reach them . . . .[47]

In August 2012, four months after the JOBS Act passed, the SEC "proposed a rule that would remove the general solicitation ban in certain Rule 506 offerings in

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accredited investors, but "qualified institutional buyers," and is, therefore, beyond the scope of this Note.

[41] 15 U.S.C. § 77d(b) (2012).

[42] Pub. L. No. 112-106, § 201(a)(1).

[43] *Supra* Part II.

[44] Pub. L. No. 112-106, § 201(a)(1). The SEC clarified what "reasonable steps" means, and this information is outlined in Part IV.C, *infra*.

[45] James E. Bitter & Todd B. Skelton, *Reforms for Hire: The Jobs Act Legislation*, 14 TRANSACTIONS: TENN. J. BUS. L. 13, 19–20 (2012).

[46] Remarks on Signing the Jumpstart Our Business Startups Act, *supra* note 32, at 1.

[47] James Hamilton, *SEC Officials Discuss General Solicitation Ban and 500-Shareholder Limit at House Hearing*, SEC NO-ACTION LETTER WEEKLY (CCH), June 13, 2011, *available at* 2013 WL 48312.

which sales would be limited to accredited investors and issuers would be required to take reasonable steps to verify such accredited status."[48] The SEC then submitted the proposed rule for public comments,[49] which would have required companies to file notice at least fifteen days *before* any general advertising or solicitation occurred.[50] The rules in effect before the JOBS Act only required a company to file the notice fifteen days *after* the first sale of securities.[51] The proposed rule also required additional information to be filed on the Form D, as well as disqualification from the use of the exemption for a period of one year if the issuer did not comply with the filing requirements at the securities offering.[52]

The SEC did not adopt the final rule until almost a year later in July 2013, and the rule did not take effect until September 23, 2013.[53] The final rule does not require the predisclosure requirement or the additional information, but these considerations have been submitted for public comment as a proposed amendment.[54] The final rule adds a new checkbox to Form D so that companies may indicate they are relying on the general advertising exemption,[55] and it prohibits felons and other "bad actors" from participating in a Rule 506 offering.[56] In addition, as detailed below, the SEC has provided further guidance on what Congress intended to be "reasonable steps" to ensure investor accreditation.

C. Definition of "Reasonable Steps"

Congress tasked the SEC with the job of clarifying what "reasonable steps" issuers of securities must take to ensure that a potential investor is actually accredited.[57] Before the Act, it was fairly easy for an issuer to determine that an

[48] *Fact Sheet: Proposing Amendments to Private Offering Rules*, U.S. SEC. & EXCH. COMM'N (July 10, 2013), http://www.sec.gov/news/press/2013/2013-124-item3.htm.

[49] *Public Comments on SEC Regulatory Initiatives Under the JOBS Act*, U.S. SEC. & EXCH. COMM'N (June 25, 2012), http://www.sec.gov/spotlight/jobsactcomments.shtml.

[50] *Fact Sheet: Proposing Amendments to Private Offering Rules*, *supra* note 48.

[51] *Id.*

[52] *Id.*

[53] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, [2013 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,321, (July 10, 2013) [hereinafter Rule 506 Amendments], *available at* 2013 WL 5823910.

[54] *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 34-69960, Investment Company Act Release No. IC-30595, 2013 WL 4413723, at *9 (July 10, 2013).

[55] Rule 506 Amendments, [2013 Transfer Binder] Fed. Sec. L. Rep. ¶ 80,321.

[56] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Exchange Act Release No. 33-9414 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

[57] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012).

investor was accredited; for the most part, the issuer only had to ask the investor to sign a paper in which the investor declared he was accredited.[58] When the SEC released its proposed rule, it "stated its belief that promulgating specific methods for determining accredited investor status would be impractical and potentially ineffective in light of the wide range of verification issues that may arise in connection with a particular offering."[59] In its final rule, the SEC announced four possible "reasonable steps" to ensure accreditation.[60]

First, to determine whether the investor meets the annual income requirement, the issuer must obtain an Internal Revenue Service (IRS) form showing the past two years of income, along with "the potential investor's written statement that the current year's income will also meet the threshold."[61]

Second, in determining the net worth of the potential investor, the issuer may use bank, brokerage, or other securities holdings statements; certificates of deposit; tax assessments; and appraisal reports.[62] The issuer may then "rely on a credit report for liabilities. The potential investor would have to declare in writing that all liabilities have been disclosed."[63]

Third, an issuer may "rely on written confirmation from a registered broker-dealer, an SEC-registered investment advisor, a licensed attorney, or a certified public accountant that it has verified the purchaser's status within the last three months."[64] This list is not exclusive; it is possible that other parties may be able to verify the investor's status.[65]

And finally, if an issuer has included an investor in a Rule 506 offering in the past and that investor was accredited, then the issuer only has to require that the investor certifies that he is still accredited.[66]

Beyond these four steps, issuers are also required to "consider the nature of the purchaser and the type of accredited investor the purchaser claims to be, the amount and type of information available on the purchaser, and the nature of the offering and solicitation."[67]

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[58] *See* 17 CFR § 230.506(b)(2)(ii) (2011) (requiring issuers to "reasonably believe" investors are accredited).

[59] James T. Carroll et al., *JOBS Act: SEC Adopts Rules to Permit General Solicitation and Advertising for Private Offerings*, PERKINS COIE (July 11, 2013), http://www.perkinscoie.com/jobs-act--sec-adopts-rules-to-permit-general-solicitation-and-advertising-for-private-offerings-07-10-2013/.

[60] Randolph Walerius, *SEC Lists Four "Reasonable Steps" to Identify Accredited Investors Under Amended Rule 506*, CQ ROLL CALL (July 10, 2013) *available at* 2013 CQSECRPT 0906 (Westlaw Citation).

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.*

V. IMPLICATIONS FOR COMPANIES

It is important for companies to remember that the new rule did not replace the old rule; it simply added another way to raise money under Rule 506(c). Therefore, an issuer still is allowed under Rule 506(b) to continue to sell to at most thirty-five "sophisticated" non-accredited investors, so long as no general advertising or general solicitation is involved.[68] It is likely that during this time of transition and uncertainty, "most startups will continue to conduct their fundraising this way for the time being."[69]

But what about the companies that wish to advertise to the general public? The obvious benefit and purpose of the Act is to allow new companies to reach beyond their existing connections. Under the new rule, companies may use "tools such as blogs, e-mail newsletters and social media" to target accredited investors they would not have access to otherwise.[70]

Although companies may solicit accredited investors, the new rule imposes safeguards, such as the "reasonable steps" outlined above, to ensure companies verify that these investors actually are accredited. "The SEC has clearly stated that having an investor check a box on a questionnaire is not sufficient to verify accredited investor status, absent additional information about the purchaser."[71] This verification process will take time and could be quite costly. Finally, the rules for filing a Form D are different under 506(c): a company must file within fifteen days of receiving the first investment.[72]

VI. IMPLICATIONS FOR INVESTORS

Before the ban was lifted, the North American Securities Administrators Association (NASAA)[73] found that the most frequent investigative and enforce-

[68] 17 CFR § 230.506(b) (2011).

[69] *SEC Lifts Ban on General Solicitation in Certain Private Placements: What Does It Mean for Entrepreneurs?*, COOLEY LLP (July 16, 2013), http://www.cooley.com/SEC-lifts-ban-on-general-solicitations-in-certain-private-placements-what-it-means-for-entrepreneurs.

[70] *Id.*

[71] *Id.* For examples of cases where investors merely signed a paper saying they were accredited, see United States v. DeSantis, 134 F.3d 760, 762 (6th Cir. 1998); Wright v. Nat'l Warranty Co., 953 F.2d 256, 260–61 (6th Cir. 1992) (rejecting the argument that plaintiffs were not accredited because plaintiffs warranted in the subscription agreement that they were accredited); and Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Woodhead, 917 F.2d 752, 754 (2d Cir. 1990).

[72] Tanya Prive, *General Solicitation Ban Lifted Today—Three Things You Must Know About It*, FORBES (Sept. 23, 2013, 12:00 AM), http://www.forbes.com/sites/tanyaprive/2013/09/23/general-solicitation-ban-lifted-today-three-things-you-must-about-it/.

[73] NASAA is the "oldest international organization devoted to investor protection." *About Us*, N. AM. SEC. ADM'RS ASS'N, http://www.nasaa.org/about-us/ (last visited Apr. 7, 2014). All fifty states are members of this organization. *Id.* Its purpose is to create resolutions and model rules to protect "main-street" investors—everyday, average investors

ment action by state securities regulators was "[f]raudulent private placement offerings." [74] Because these investments are "highly illiquid, generally lack transparency and have little regulatory oversight[,] . . . they carry high risk and may not be suitable for many individual investors."[75]

NASAA argued that the JOBS Act would only exacerbate what was already the most significant concern of the states, due to the fact that states are preempted from requiring registration of securities exempted by Regulation D.[76] NASAA warned that the JOBS Act would bring Rule 506 offerings to "social media, billboards, or t-shirts on window washers as one startup has proposed."[77]

State securities regulators across the nation are also apprehensive about the change in Rule 506. These regulators believe that the "integrity of the market" is at risk by allowing "small, speculative companies and high-risk hedge funds to raise money through public advertising." [78] The state securities commissioner of Arkansas said, "You can't just open the door of a new way of offering securities without ensuring the integrity of the market . . . [a]nd the idea that the accredited investor is a sophisticated investor is ridiculous."[79]

Conversely, many scholars, politicians, and business people have argued that the risks of lifting the general advertising ban are outweighed by the benefits. Professor William K. Sjostrom Jr. argued in 2004 that:

> While the ban may help prevent securities fraud, it has a much greater impact on the ability of an honest, legitimate company to attract investors since, in light of the ban, such a company will not engage in any general

—at the state and federal level. *Regulatory and Legal Activity*, N. AM. SEC. ADM'RS ASS'N, http://www.nasaa.org/regulatory-activity/ (last visited Apr. 7, 2014). NASAA also works with the federal government to ensure coordination and standardization of rules. *Id.*

[74] *NASAA Expands Annual Top Investor Threat List: JOBS Act Implementation Prompts Additions of Threats to Small Business Owners*, N. AM. SEC. ADM'RS ASS'N (Oct. 15, 2013), http://www.nasaa.org/27012/nasaa-expands-annual-top-investor-threats-list/.

[75] *Id.*

[76] *Id.* ("[S]cam artists are likely to use this legally permissible avenue to their advantage leading, no doubt, to another year of Rule 506 offerings holding the top spot as the most frequent source of state securities enforcement actions."); *The Jobs Act: An Investor Protection Disaster Waiting to Happen*, N. AM. SEC. ADM'RS ASS'N (Mar. 22, 2012), http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/ ("Since NSMIA, the provisions of Rule 506 and other limited or private offering provisions are being used by unscrupulous promoters to evade review and fly under the regulatory radar with little scrutiny by the SEC.").

[77] *NASAA Expands Annual Top Investor Threat List*, *supra* note 74.

[78] Peter Lattman, *S.E.C. Lifts Advertising Ban on Private Investments*, N.Y. TIMES (July 10, 2013, 4:04 PM), http://dealbook.nytimes.com/2013/07/10/s-e-c-lifts-advertising-ban-on-private-investments/?_php=true&_type=blogs&_r=0.

[79] *Id.* (quoting A. Heath Abshure, Arkansas State Securities Commissioner).

> solicitation or advertising, whereas someone willing to perpetrate securities fraud likely is not troubled in the least by violating the ban.[80]

Sjostrom additionally argued that while the ban should be lifted, it should be limited to emerging companies who need the access to capital the most and make considerable contributions to the economy.[81] He argued that this would allow access to emerging companies to "latent angel investors"—those who are ready and willing to invest in these private placement offerings but cannot be accessed through the traditional route and, therefore, may only be found through general advertising.[82] Finally, Sjostrom wanted to limit these offerings through registered broker-dealers or certain persons associated with the issuer.[83]

VII. CHANGING THE ACCREDITED-INVESTOR STANDARD

This section defines what it means to be an accredited investor, which currently is solely a wealth-based standard. In doing so, it argues that this standard is an insufficient evaluator of qualified investors because it fails to take into account investor sophistication and other factors, such as age and disability. These considerations show that the SEC may be ignoring those investors that are most likely to suffer serious financial harm. Therefore, this section proposes a model for a new accredited-investor standard that takes into account investor financial sophistication, places a limit on the percentage of net worth/annual income that may be invested in any one exempted security, and requires upfront disclosures from the issuer. Finally, this model proposes lowering the wealth threshold in order to allow financially sophisticated investors to participate.

A. Definition of Accredited Investor

As introduced in Part II.B above, an accredited investor is defined as someone who either has (1) a net worth of at least $1 million at the time the purchase is made (either individually or joint net worth with a spouse) or (2) an annual income of at least $200,000 for each of the past two years or a joint income of at least $300,000 during that same period, and a "reasonable expectation" that income will remain the same or increase in the current year.[84]

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[80] Sjostrom, Jr., *supra* note 9, at 42.

[81] *Id.* at 45–46.

[82] *Id.* at 47.

[83] *Id.* at 45–46. For the requirements of the "associated persons of an issuer deemed not to be brokers," see 17 C.F.R. § 240.3a4-1 (2012).

[84] 17 CFR § 230.501; *see also Fact Sheet: Eliminating the Prohibition on General Solicitation and General Advertising in Certain Offerings*, *supra* note 13.

This rule was amended in 2010 with the Dodd-Frank Act.[85] Dodd-Frank prohibited considering a person's primary residence in the calculation of net worth. It is estimated that this standard "limit[s] equity investment in private companies to approximately 2 percent of the American population."[86] Dodd-Frank also "requires the SEC to periodically review this accredited investor standard every four years and make adjustments 'as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy.'"[87] The standard was adopted in an effort to ensure that those who need the protection of the securities laws the most are covered, and those who do not may take high risks with the potential of high returns.[88] The SEC explained that its "considerable regulatory experience with the use of the term 'accredited investor' leads us to believe it strikes the appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities, especially small businesses."[89]

B. Why the Accredited-Investor Standard Is Insufficient at Protecting Investors

There are several disadvantages to using the accredited-investor standard as a way of weeding out potential investors who need the protection of the securities laws. First, the greatest weakness of this standard is that it does not take into account an investor's financial sophistication, only the amount of wealth an investor has accumulated. A second issue is the confusion this standard has produced over whether investors need to be accredited or sophisticated, especially since courts use the two terms interchangeably even though they are different standards for different purposes. Finally, the groups that are most likely to suffer irreparable financial harm from this standard are those most likely to benefit from investor protection, such as the elderly.

1. The Standard Does Not Consider Investor Sophistication

The accredited-investor standard does not consider financial sophistication. The focus of the standard is merely on net worth or annual income, with no inquiry into the knowledge a potential investor may have regarding securities, risk, or the

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[85] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010).

[86] KAUFFMAN FOUND., STATE OF ENTREPRENEURSHIP ADDRESS: FINANCING ENTREPRENEURIAL GROWTH 6–7 (2013), *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2013/02/soe%20report_2013pdf.pdf.

[87] Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 51 n.3 (2012) (quoting the Dodd-Frank Act).

[88] SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953).

[89] Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, 66 Fed. Reg. 66,839, 66,840 (proposed Dec. 27, 2001) (to be codified at 17 CFR pt. 230).

particular transaction.[90] Therefore, someone with money and absolutely no experience in the financial industry may now invest in very high risk private offerings. Conversely, a professor from a typical university with a doctoral degree in finance will most likely not be accredited and yet is clearly aware of the risks of investing in a new venture.

Another issue with basing the standard on net worth or annual income is the possibility that the "net worth computation [is based] on liberally appraised illiquid assets or on the assets of a spouse. An investor accredited solely by income . . . may actually be insolvent at the time of purchase."[91] The standard also fails to consider diversification: an investor with a net worth of $1 million could potentially invest all of that money with one company and lose all of her life savings at once. These criteria are incomplete indicators of whether an "investor is able to bear the risk of losing the invested funds."[92]

Rather than looking at an investor's involvement in the finance industry, the SEC regulation "relies on the status of individual investors . . . to determine whether substantial regulation is necessary."[93] To justify its standard, the SEC reasons that "wealthy investors are always sophisticated or that they, no matter how naive, do not need the protection of the 1933 Act's registration provisions."[94] But this assumption is flawed because it views an investor as black or white—either deserving of the SEC's protections or not. In reality, "[i]nvestors possess vastly different degrees of financial sophistication. Some are institutional investors or professionals with vast resources, educations from top business schools, and substantial investment experience. Others are individuals with few resources, little or no education, and even less experience in the securities markets."[95] There is a wide spectrum of sophistication and wealth, and the two do not always go hand in hand.

The Bernie Madoff scandal is an excellent example of the inadequacy of the accredited-investor standard. Madoff ran a well-known investment advisory business and was also a former NASDAQ chairman.[96] He headed a popular hedge fund where investors "clamored to be in [the fund] because of the stability of

[90] *See* Martin, *supra* note 87, at 51 n.3 ("[K]nowledge is not a prerequisite for becoming an accredited investor."); 17 C.F.R. § 230.501(a) (2011) (defining "accredited investor").

[91] 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).

[92] *Id.*

[93] Martin, *supra* note 87, at 52.

[94] C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1124.

[95] *Id.* at 1083.

[96] *Ex-Nasdaq Chair Arrested for Securities Fraud*, CNN MONEY (Dec. 12, 2008, 6:22 AM), http://money.cnn.com/2008/12/11/markets/madoff_fraud/.

double-digit returns and the reports of serious wealth creation."[97] This hedge fund was one of the largest Ponzi schemes in history, however.[98] Investors lost over $20 billion in this scheme.[99] Many of the investors were wealthy or institutional investors, but most had "little to no financial acumen . . . [and lost] their entire fortunes to Madoff's Ponzi scheme."[100]

Of course, the wealthy are better able to afford assistance with their finances, including the use of broker-dealers. Hiring someone who is financially savvy may make up for investors' lack of sophistication. Yet, there are two main issues with this argument: investor overconfidence and other biases. A 2007 study from Princeton University[101] showed that investors tend to be overconfident in looking at future earnings:

> People tend to be unrealistically optimistic about their future financial wealth. As a consequence, they often fail to save enough for retirement, and they make investment choices that are riskier than they can afford. As a result of this bias, people often are not well-prepared for retirement or other future financial endeavors.[102]

Investors are also subject to several other biases. These biases include the "Blind Spot," where investors may be able to see others' biases or influences on judgment but are unable to see their own.[103] Another bias is the "Halo Effect," where investors tend to see certain people in a more positive light, without actually knowing whether they are "deserving of such positive judgment."[104] The study showed that this bias "could be damaging, if it led people to overlook the importance of getting a background check on a broker before investing, and if it led people to invest more money than they should."[105] Therefore, through a combination of investor overconfidence and bias, it is unlikely that the ability to hire someone financially savvy actually makes up for a lack of financial sophistication.

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[97] Robert Lenzner, *Bernie Madoff's $50 Billion Ponzi Scheme*, FORBES (Dec. 12, 2008, 6:45 PM), http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in_rl_1212croesus_inl.html.

[98] *Id.*

[99] Martin, *supra* note 87, at 52.

[100] *Id.*

[101] *See generally* FINRA INVESTOR EDUC. FOUND., OVERCOMING BIASES TO PROMOTE WISE INVESTING (2007), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p118416.pdf.

[102] *Id.* at 4.

[103] *Id.* at 2.

[104] *Id.* at 3.

[105] *Id.*

2. Mistaken Assumptions About "Accredited" and "Sophisticated" Investors

A major issue with the accredited-investor standard is the assumption that accredited and sophisticated investors are one in the same. A sophisticated investor is defined as one who has "sufficient knowledge and experience in financial and business matters to [be] capable of evaluating the merits and risks of the prospective investment."[106] Courts may also take into account several factors to determine investor sophistication, such as "wealth[,] . . . age, education, professional status, investment experience, and business background."[107]

Judges often have delivered opinions expressing the idea that because an investor is accredited, he must be financially savvy.[108] One judge found that because the investor was "an accredited investor under the Federal Securities laws[,] . . . he certainly ha[d] some 'sophistication and expertise . . . in financial and securities matters.'"[109] It does not necessarily follow, however, that because an investor meets certain monetary standards, he must have "sophistication and expertise" in finance.

A Seventh Circuit opinion found in another context that certain contract participants were the "equivalent of 'accredited investors' in securities markets: wealthy persons who can look out for themselves."[110] One financial professional found that "often people whose net worth puts them in the accredited category . . . may be smart and successful in their fields, but most are confused about the basics of investing and managing money."[111]

The upshot is that a wealthy investor is not always a sophisticated investor. Conflating the accredited standard with the sophisticated standard can harm investors who need and warrant the protection of federal securities laws. As Justice William O. Douglas famously dissented, "[t]he [Securities] Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market."[112]

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106 *Rule 506 of Regulation D, supra* note 11.

107 Banca Cremi v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1029 (4th Cir. 1997) (alterations in original) (internal quotation marks omitted).

108 *See, e.g.*, Poth v. Russey, 99 F. App'x 446, 455 (4th Cir. 2004).

109 *Id.* (citation omitted) (quoting Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118, 123–24 (4th Cir. 1990)).

110 Commodity Futures Trading Comm'n v. Zelener, 373 F.3d 861, 862 (7th Cir. 2004).

111 John E. Girouard, *The Sophisticated Investor Farce*, FORBES (Mar. 24, 2009, 12:30 PM), http://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html?partner=contextstory.

112 Scherk v. Alberto-Culver Co., 417 U.S. 506, 526 (1974) (Douglas, J., dissenting).

3. The Accredited-Investor Standard Harms the Elderly and Others Most in Need of Protection

As outlined in Part VII.A, the accredited-investor standard does not always equate to actual wealth and the ability to take significant financial risk.[113] "[T]he categories of 'wealthy' investors frequently include the widows and orphans whose protection traditionally has been the sacred trust of the SEC. . . . [They] often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment."[114]

In some circumstances, a person may have a net worth of $1 million, but this could be due to an insurance settlement or a retirement account that has vested. A million dollars may seem like a lot of money—until you consider the fact that a person may need to live off of that money for twenty years or more. Taking into account inflation, that money is even less. At an advanced stage in life, that money is even harder to earn back once it is lost. At the state level, scams involving abuse of the elderly constitute about one in six enforcement actions.[115] "Given the financial threshold for an accredited investor, . . . elderly people, who may even suffer from mental illness, are prime targets for companies looking for investors."[116]

SEC Commissioner Luis Aguilar—the sole dissenting vote in the adoption of the new rules lifting the ban on general advertising—pointed out the major error with the assumption that accredited investors are "knowledgeable about financial matters and otherwise able to fend for themselves."[117] As outlined above, being accredited does not equal being financially sophisticated. In fact, "only a small percentage of U.S. households meeting the definition of accredited investor have substantial direct holdings of individual securities, suggesting that their experience investing in securities may be limited."[118] Aguilar asserts that elderly investors will not be protected for being accredited, "but in fact made more vulnerable because of

[113] *See* Editorial, *Risky and Getting Riskier*, N.Y. TIMES (Aug. 31, 2012), http://www.nytimes.com/2012/09/01/opinion/risky-and-getting-riskier-for-investors.html?_r=2&adxnnl=1&adxnnlx=1382661276-2vBCmX4PcorZMvPW8dVIaQ (pointing out that "wealth and earnings are often no indicator of investing experience").

[114] Warren III, *supra* note 91, at 382.

[115] *Enforcement Statistics: NASAA Member Enforcement Statistics 2012*, N. AM. SEC. ADM'RS ASS'N, http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics/ (last visited Apr. 7, 2014).

[116] Hugo Gallegos, *The JOBS Act and Lifting the Ban on General Solicitation and Advertising: Is the U.S. Ready for Investment Opportunity Infomercials?*, 25 LOY. CONSUMER L. REV. 448, 460 (2013).

[117] Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Facilitating General Solicitation at the Expense of Investors (July 10, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539684712#.Umm9zZG-9jR.

[118] *Id.*

it."[119] It may be difficult for even moderately sophisticated investors to understand the risks involved in unregistered securities, but elderly investors with no financial literacy are the most at risk.

C. A Model for a New Standard

Lifting the ban on general advertising has some potential advantages. It is easier than ever for companies to tap into latent investors who are willing to invest but lack the personal connections. This benefits companies seeking to access funding, investors, and on a larger scale, the economy. However, along with the removal of the ban, the accredited-investor standard should change. Otherwise, private-placement exemptions under Rule 506, which already are the number one source of fraudulent transactions, will only become riskier. This will undermine any efforts to improve the relationship between buyers and sellers. And the decrease in consumer confidence will harm the economy.

Therefore, this Note proposes a new standard for accrediting investors. This standard is a hybrid of the accredited and sophisticated standards. The components of this standard include, most importantly, an inquiry into financial sophistication, a lower floor requirement for wealth, a diversification requirement, and upfront disclosures. Each will be discussed in turn.

(1) **Financial Sophistication**. In addition to verifying wealth, an investor *must also* be financially sophisticated. This could be determined by a variety of factors, including financial education, experience in the finance industry, or possibly a test or certification that can be taken to prove financial sophistication.[120] A combination of these factors may also be enough. An exception to this rule would be if an investor lacks the mental capacity to act on his own behalf but has a sophisticated guardian/custodian who makes all financial decisions on behalf of the investor.

(2) **Wealth Verification**. This model would use an income and net worth verification system similar to the standard used today, but would allow for a lower floor requirement (e.g., \$500,000 net worth or \$100,000 annual income). This allows for very sophisticated investors, who may not be as wealthy, to participate in private offerings. Similar to today's rule, primary residence or any loans secured by the residence should not be included in net-wealth calculations.[121] It could also

[119] *Id.*

[120] Professor Stephen Choi proposed "a licensing system whereby investors, prior to engaging in any securities transaction, obtain a license from the SEC as issuer-, intermediary-, or aggregate-level investors. Investors who fail to receive a license are treated as presumptively unsophisticated." Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 310 (2000).

[121] *See* Press Release, SEC Adopts New Worth Standard for Accredited Investors Under Dodd-Frank Act (Dec. 21, 2011), *available at* http://www.sec.gov/news/press/2011/2011-274.htm (explaining the purpose of excluding the primary residence is "to prevent manipulation of the net worth standard, by eliminating the ability of individuals to

be worthwhile to exclude IRAs and other retirement plan balances from net worth calculations of individuals close to retirement, who would otherwise be unable to re-create those investments if their savings were lost.

(3) **Diversification**. The idea behind this requirement is that a person should not put all of his eggs in one basket. If an investor wants to invest in unregistered securities, he should only be allowed to invest a certain percentage of his income or net worth to ensure that if the securities fail or are fraudulent, the investor will not lose all of his savings. For example, if an investor has $1 million in net worth, he should not be able to invest more than 10% or $100,000 with any one issuer. This will protect the elderly or those who are not easily able to regain wealth if all is lost.[122]

(4) **Upfront Disclosures**. Rather than requiring companies to file a Form D after the securities are sold, the proposed standard would require it to be filed up front (similar to the proposed amendment offered by the SEC). In addition to the Form D, companies would be required to deliver potential investors a private placement memorandum (PPM) *before* purchasing any securities, informing the investor that they are involved in a private offering under an exemption, that the risk is very high, and that it is possible for the investor to lose all of her money.[123] This disclosure must be signed by both the investor and the issuer.

There are, of course, several disadvantages to this proposed standard. The standard is more nuanced and less straightforward than the current standard that only measures wealth. Because it is more complex, it may expose an issuer to a greater amount of risk in attempting to comply with the standard and, therefore, would cost more money to ensure compliance. The wealth standard may be determined easily by looking at IRS documents or bank statements, whereas the proposed standard would require all that in addition to verifying the investor's sophistication and providing documents up front. By the time it came time to actually invest, many investors may be scared off or will have moved to other less

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artificially inflate net worth under the new definition by borrowing against home equity shortly before participating in an exempt securities offering"); *supra* Part VII.A.

[122] A diversification requirement is already built in to the Crowdfunding section of the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (CROWDFUND Act). *See* Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315–23 (2012). Under the Crowdfunding section only, Congress recognized the need to limit the total percentage of wealth a person can invest. The limitations here are even stricter than what this Note proposes: in any twelve month period an investor with fewer than $100,000 in net worth or annual income may contribute only 5% of the investor's annual income or net worth or $2,000 (whichever is greater). *Id.* § 302(a)(6)(i). An investor with equal to or more than $100,000 in annual income or net worth may invest 10% of his annual income or net worth, not to exceed $100,000. *Id.* § 302(a)(6)(ii).

[123] Under Rule 506(b), PPMs or something similar are required for all non-accredited investors. Since 506(c) requires all investors to be accredited and it lacks the language requiring the PPM, it is possible that issuers could avoid giving these robust disclosures. This Note's standard fills this gap by requiring accredited investors to also receive a PPM.

risky investments. But that is the point—private-placement offerings are not for the weak of heart or the risk-averse investors. These investments are riddled with risk but also the potential of high returns, and there is certainly a sector of the population willing to take those risks. It is a matter of ensuring the right investors are paired with the right issuers.

VIII. CONCLUSION

Lifting the ban on general advertising and general solicitation will ultimately change how emerging companies receive funding. With greater access to previously untapped investors, more new businesses will be able to get on their feet and be successful. This success depends on the regulation of these offerings to ensure they are free of fraud and that investors maintain confidence in the market.

As the standard currently stands, it is likely that the removal of the ban will result in a regulatory gap, which may take advantage of several investors. The accredited investor standard should be changed to reflect not only individual wealth, but also financial sophistication. It should require disclosure of the risks up front and a diversification requirement. This will ensure a “meeting of the minds” between the issuer and the investor and produce a more stable market for private-placement offerings.