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REVISITING THE ACCREDITED INVESTOR STANDARD

Syed Haq

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the Jumpstart Our Business Startups (JOBS) Act provided the impetus for several changes in the financial regulatory regime. In the securities markets, Dodd-Frank included provisions that lifted a ban on general solicitation and mandated a review of the accredited investor standard.[1] These changes, while intended to increase capital formation within our private markets, also brought to light serious investor protection issues. This note advocates for a new accredited investor standard that more accurately reflects the risks associated with investing in the private markets.

Section I of this note will describe the formation of the current accredited investor standard. It will discuss how private placements were traditionally determined by whether an investor had the proper sophistication to participate in the transaction. It will also explain how the entry qualification has changed to a loss-bearing standard through the current standard. Section II of this note will assess possible reasons why a gatekeeping role exists for private markets. It will distinguish private placement transactions from those that occur through registered offerings.

Section III of this note will present the problems arising from the current accredited investor standard. Specifically, it will seek to divorce wealth from serving as a proxy for sophistication. To this end, it will analyze institutional failures and behavioral biases that exist for the wealthiest investors, as well as the various methods of wealth accumulation. Finally, it will describe how the current standard does not adequately evaluate the loss tolerance of an investor, and leaves a substantially large class of individuals unprotected.

Section IV of this note evaluates the policy considerations for private market participation. It offers a way to curb risks associated with offerings in private markets. It argues that the primary goals should include investor sophistication and loss bearing, while also taking into account capital formation. Section V offers a basic outline that would advance these goals.

I. Background: The Rise of the Accredited Investor

In order to understand the necessity of an accredited investor standard it is important to distinguish between the private and public markets. The Securities Act of 1933 ("Securities Act") created this distinction in Section 5 by requiring registration of securities sold by issuers unless they were

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 413(b), 124 Stat. 1376, 1577-78 (2010); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–15 (2012).

exempt.[2] The seminal case of *SEC v. Ralston Purina* limited private offerings to only those investors who were able to "fend for themselves."[3] These investors do not require the benefits of registered securities because they are able to substantiate their own sophistication to alleviate disadvantages created by the lack of oversight by the Securities and Exchange Commission ("SEC"). The legislative history that ultimately culminated in the current accredited investor standard exemplifies the importance of investor sophistication to this standard.

A. *Legislative History of Rule 4(a)(2)*

The history of the current accredited investor standard can be traced back to the late 1920's amidst the greatest economic depression that the U.S. capital markets has ever experienced. The period just before the stock market crash of 1929 was fraught with investor speculation. Among other reasons, it was fueled by investor confidence that the newly established Federal Reserve would help alleviate the volatile stock markets characterized by booms and busts.[4]

Increased confidence resulted in greater speculation by investors. Traders would routinely use debt to leverage their investments in the hopes of stronger returns.[5] Investors continued to buy securities despite numerous recommendations that indicated the instability of stock prices.[6] Unfortunately, the period leading up to the market crash was characterized by a lack of analytical considerations in favor of "pseudo-analysis" that pushed the market upwards.[7] On Thursday, October 24, 1929 the market collapsed with billions of dollars lost. The Federal Reserve blamed the crash on market speculation.[8]

Although the market crash had a devastating effect on most of the country, some in the industry had predicted its occurrence. Roger Babson's United Business Service advised the sale of stocks in September and October of 1929 because of "tight money."[9] Additionally, some experienced market participants were able to avoid the loss. Eugene Meyer,

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2. Securities Act of 1933, 15 U.S.C. §§ 77d-e.

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

4. Edward Chancellor, Devil Take the Hindmost: A history of financial Speculation 192 (2000); Felicia Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor,"* 40 U. Bal. L. Rev. 215, 244 n. 126 (2010).; Investors borrowed as little as 10% of their total investment in order to complete their purchase. *See* Croft Communications, *Causes*, The Great Depression (2015), http://thegreatdepressioncauses.com/causes/.

5. *See* Chancellor, *supra* note 4, at 192.

6. Barrie A. Wigmore, The Crash Its Aftermath: A history of Securities Markets in the United States, 1929 – 1933 5 (Robert Sobel ed., Greenwood Press 2015).

7. Benjamin Graham & David Dodd, Security Analysis: The Classic 1940, 11, 14 (2nd ed.2002).

8. Wigmore, *supra* note 6, at 10.

9. *Id.* at 5.

who ultimately became Governor of the Federal Reserve Board, and Percy Rockefeller, began selling their shares.[10] John Raskob, the chairman of the Democratic Party and the financial authority on the board of Du Pont de Nemours & Co., as well as General Motors Corp., followed suit.[11]

The response to the market failure came in the form of the Securities Act of 1933. The Act was predicated on providing "full and fair disclosure of the character of securities . . . to prevent frauds in [their] sale."[12] The goal was accomplished by an overall requirement to register all "securities" sold.[13] The legislation includes a broad definition of the term "securities" to presumably allow for maximum inclusion.[14] This legislation required registered securities to comply with information requirements associated with their offerings through the use of prospectuses and registration statements.[15] Additionally, the specter of civil liability provided an added incentive for the compliance of regulations.[16] Issuers could face liability not only for material misstatements but also omissions.[17]

Congress, however, allowed exemption from registration and information requirements in areas where "there [was] no practical need for its application or where the public benefits are too remote."[18] Most important of these exemptions was section 4(a)(2) of the Securities Act, which exempted "transactions not involving a public offering."[19] Congress left the term "public offerings" undefined. The Supreme Court subsequently interpreted the term in *Securities and Exchange Commission v. Ralston Purina Co*. Ralston Purina, a feed and cereal products company, had sold two million dollars worth of its common stock to its employees as a general policy of encouraging employee ownership.[20] Offers to buy securities were made to, among others, "artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterina-

10. *Id.* at 4.

11. *Id.*

12. Securities Act of 1933, 15 U.S.C. § 77a (2012) (referring to statute's preamble).

13. *Id.*

14. *Id.*

15. *Id.* § 77e(b)-(c) (2006) (requiring a registration statement to be filed before the offer of securities can be conducted, as well the filing of a prospectus before sales can be conducted); *Id.* § 77j (2006) (specifying the information required in a registration statement).

16. *Id.* § 77k (2006) (imposing liability misstatements in the registration statement); *Id.* at § 77l (imposing liability for violations in complying with registration requirements and false communications in the prospectus).

17. *Id.*

18. H. R. Rep. No. 73-85, at 5 (1933).

19. 15 U.S.C. § 77d(a)(2) (2006).

20. Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 121 (1953).

rian."[21] The SEC brought suit alleging that the company sold securities without proper registration under Section 5 of the Securities Act.[22]

Interpreting the claim that Ralston Purina's securities were exempt from registration requirements since its transactions were not associated with a public offering, the Court determined that the availability of the exemption should be based on "whether a particular class of persons affected needs the protections of the act."[23] The measure for this determination, the Court concluded, was whether persons were able to "fend for themselves."[24] Although the court determined that Ralston's offerees did not fit this criteria, it also stated that corporate executives may fit this criteria because of their access to the type of information available in a registration statement.[25] Investor sophistication and access to information became key factors for the courts in deciding whether a transaction qualified as a private offering.[26]

B. *Regulation D and the Accredited Investor Standard*

In order to provide more clarity to issuers and investors the SEC sought to interpret the *Ralston Purina* decision through the use of an accredited investor standard. In 1974, the SEC adopted Rule 146, which required that investors be financially sophisticated enough to be offered private placements based on their knowledge and experience, capability of evaluating the risks and merits, and ability to bear the economic risk of the investment.[27] Special attention was paid to whether investors could afford to hold their investments for an indefinite period, and if they could afford a total loss.[28] Borrowing from *Ralston Purina* and its progenies, the rule also required that the issuer believe that the offeree have such knowledge and experience in financial and business matters that he is capable of evaluating the risks and merits of the prospective investment.[29]

Though meant to be an objective standard, Rule 146 still suffered from several problems. In 1980, Congress included amendments in the Securities Act to provide incentives for small businesses.[30] The statute contained

21. *See id.* at 121.

22. *Id.* at 120.

23. *Id.* at 124-25.

24. *Id.* at 125.

25. *Id.* at 125-26.

26. *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 903 (5th Cir. 1977) (discussing the need for both investor sophistication and access to information to comply with *Ralston Purina*).

27. Gov't Accountability Office, GAO-13-640 SECURITIES AND EXCHANGE COMMISSION: Alternative Criteria for Qualifying AS An Accredited Investor Should Be Considered 8 (2013), http://www.gao.gov/assets/660/655963.pdf.

28. *Id.*

29. Charles Johnson & Joseph McLaughlin, Corporate Finance and the Securities Laws 7-13 (4th ed. 2013).

30. Small Business Investment Incentive Act of 1989, Pub. L. 94-477, 94 Stat. 2275.

the concept of an accredited investor and specified institutions that may qualify. Additionally, Congress used the opportunity allow the SEC to further expand on the definition by considering a person's "financial sophistication, net worth, knowledge and experience in financial matters, or amounts of assets under management."[31] By this time, lawmakers had begun to abandon the difficult factor driven test, in favor of a more bright-line concepts. The SEC used this rule making authority to create Regulation D. The regulation allowed private placements to be offered based on three exemptions – Rule 504, 505, and 506.[32] Both Rules 505 and 506 limited the offering to 35 purchasers.[33] However, in the counting procedure for purchasers, accredited investors were excluded.[34] Combined with the unlimited capital raises allowed under Rule 506, issuers could raise a virtually indefinite amount of funds through a limitless pool of purchasers, as long as they were accredited investors.

An accredited investor, defined in Rule 501 of Regulation D, includes institutional investors, insiders, as well as individuals.[35] Specifically, an individual can qualify as an accredited investor if their net worth exceeds $1 million, excluding the value of their primary residence.[36] They can also qualify if their income is above $200,000 in the past two years, with the expectation that it will stay stagnant in the current year.[37] Finally, the test was revised to include a spouse's income, expanding the threshold to $300,000 in annual income.[38] These tests were presumed to ensure that accredited investors possessed the requisite sophistication to comprehend the risks and benefits associated with their investments.[39]

II. Differentiating the Private Placement and Registered Markets

Investor sophistication continues to play a prominent role in the design of the accredited investor standard. In the years after the stock market crash, perhaps recognizing that there were sophisticated individuals who were not misled by the ramped market speculation, Congress allowed the section 4(a)(2) exemption from registration.[40] The exemption was interpreted by the Supreme Court to apply only to those individuals who could

31. 15 U.S.C. § 77B(a)(15)(ii) (2015).

32. 17 C.F.R. §§ 230.504-06.

33. 17 C.F.R. §§ 230.505(b)(2)(ii), 230.506(b)(2)(i).

34. 17 C.F.R. § 230.501(e)(1)(iv) (stating that "for the purposes of calculating the number of purchasers under [Rule 505 and 506] . . . the following purchasers shall be excluded . . . [a]ny accredited investor").

35. 17 C.F.R. § 230.501(a).

36. *Id.*

37. *Id.*

38. *Id.*

39. *See* Felicia Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor,"* 40 U. Bal. L. Rev. 215, 251 (2010).

40. 15 U.S.C. § 77d(a)(2) (2006).

"fend for themselves."[41] This interpretation led the SEC to design Rule 146, which sought to isolate whether an investor had the necessary sophistication to evaluate the risks of the investment. The current iteration uses wealth as a proxy for the assessment of the same sophistication as its predecessor sophistication. In order to understand the need for sophistication in the private market, it is necessary to distinguish it from the public markets. In the public market, there is no sophistication requirement, nor is it necessary to maintain a certain amount of wealth. Still, the SEC allows any and all participants to engage in trading.[42] Since the *Ralston Purina's* case phrased that the participants in a private offering must be able to fend for themselves, by reverse implication, public market participants are either able to protect themselves or are protected by others. The core difference between the two markets is the SEC disclosure regime, and our acceptance of the efficient market hypothesis.

A. *The SEC Disclosure Regime*

The registration of securities for public offerings is accompanied by several disclosure obligations. Based on Section 5 of the Securities Act, any sale of securities must accompany with it a prospectus complying with Section 10 of the Securities Act.[43] Section 10 prospectuses require information that is contained in the registration statement.[44] This includes information about the company's financials,[45] special instances for the use of proceeds[46], as well as general information about the company and its business.[47] Additionally, after a company goes public, there are new disclosure obligations that need to be met. The Securities Exchange Act of 1934 ("Exchange Act") requires periodic filings through the use of Form 10-K and Form 10-Q, and also requires Form 8-K filings in special circumstances.[48]

One of the key reasons for investor sophistication is to assess the ability of individuals to be able to distinguish information that is useful from that which is not. The Fifth Circuit expanded on this point in *Doran v.*

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

42. Although trading is now generally conducted by large institutional investors, there is still a significant portion of trades executed by individual investors. While institutional investors are generally accepted to be sophisticated, individuals may or may not carry such a trait. *See Generally* Ronald K Gilson & Jeffrey N. Gordon, The *Agency Cost of Agency Capitalism: Activist Investors and Revaluation of Goerance Rights,* 113 Colum. L. Rev. 863, 874-88 (2013); *see also* Matteo Tonello & Stephan Rabimov, The Conference Bd., Inc., The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition 22tbl.10 (2010), *available at* http://ssm.com/abstract=1707512.

43. 15 U.S.C. § 77e (2015).

44. 15 U.S.C. § 77j (2015).

45. 15 U.S.C. § 77aa(25)-(26) (2015).

46. 15 U.S.C. § 77aa (27) (2015).

47. 15 U.S.C. § 77e (1)-(8) (2015).

48. 15 U.S.C. § 78l (2015).

Petroleum Management Corp.[49] The case involved a sophisticated investor who purchased securities in an oil-drilling venture.[50] In evaluation of Petroleum Management's claim of the 4(a)(2) exemption, the court felt that it was obligated to decide if any offeree in the transaction was "blind."[51] Drawing on the reasoning in *Ralston Purina*, the court held that if the offeree simply had access to the information, as would be required in a registration statement, the relationship between the offeree and the issuer gains special importance.[52] Specifically, the offeree must have sufficient competence "to ask the right questions and seek out the relevant information."[53] Thus, sophistication isn't merely necessary to access information; it is needed to access "relevant information."

In a public market, the SEC has already made the determination of what information is relevant. For companies that trigger the Exchange Act disclosure requirements,[54] the SEC has mandated that certain financial, property, management, and legal information be disclosed to the public.[55] Additionally, issuers are expected to discuss the health of their business in the Management Discussion and Analysis section of the 10-K. Similarly, in the event that there are any material changes or non-public material disclosures, the issuer is required to file an 8-K in order to update the public.[56] Thus, public companies are required to keep the market abreast of important information affecting their businesses.

B. *The Efficient Market Hypothesis*

While sophistication is needed to access the relevant information, it is also necessary to actually comprehend the information. In the public market there are a large number of retail investors that may not have financial sophistication. However, they are able to participate in the market because of our reliance on the Efficient Market Hypothesis. When functioning effectively under the Efficient Market Hypothesis, retail investors are

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49. *See* Doran, *supra* note 26.

50. *Id.* at 897.

51. *Id*. at 902.

52. *See id*.

53. *Id*. at 905.

54. Generally the disclosure requirements can be triggered by three ways: (1) by listing one's self on an exchange, (2) by having over 2,000 holders and 10,000,000 in assets, or (3) by registering for a public offering. 15 U.S.C. §§ 78l (a)-(b), § 78o (d) (2015) (Trigger two suggests that even if the company has engaged in a number of exempt offerings, perhaps through Regulation D, after a certain level the company is sufficiently public enough to warrant investor protection).

55. *Form 10, Information Required In Registration Statement, Items (1)(2)(3)(8)*, SEC, *available at* https://www.sec.gov/about/forms/.pdf (last visited November 7, 2015).

56. *Form 8-K, General Instructions*. Sec. & Exch. Comm'n, *available at* https://www.sec.gov/about/forms/form8-k.pdf (last visited November 7, 2015).

able to take advantage of sophisticated investor's abilities when making investment decisions.[57]

The Efficient Market Hypothesis suggests that in a semi-strong form market, which competitors believe reflects the U.S. capital markets, investors are rational actors that are profit driven.[58] If the theory assumptions hold true, all publicly available information is evaluated by investment analysts and reflected in the public price for the security.[59] Investment analysts use their superior diligence methods and financial experience to decipher relevant information, and by trading on that knowledge, prevent price inflation.[60] The investor should feel secure that the price they are paying is "fair," in relation to the information available. Ultimately, this builds investors' confidence and individuals are generally able to buy and sell these securities if they have the available funds. Due to the large pool of buyers, the market is generally liquid.[61]

C. *The Private Placement Market*

The private markets operate quite differently from the public market outlined above. While the case law requires issuers utilizing the 4(a)(2) exemption to disclose information that would be similar to that contained in a registration statement, the form is not determined.[62] Additionally, the vast majority of private placements today take place under Regulation D.[63] Regulation D only mandates disclosure in the event that the participant is not an accredited investor.[64] This is presumably because accredited investors are able to fend for themselves. Still the fact remains, in a private

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57. Stephen J. Choi & A.C. Prichard, Securities Regulation: Cases and Analysis 32-34 (Robert C. Clark et. al. eds., 4th ed.).

58. *See generally* Eugene S. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 JOURNAL OF FINANCE 383 (1970).

59. *See* Jonathan Clarke, Tomas Jadik, & Gershon Mandelker, *The Efficient Market Hypothesis*, Efficient Markets Hypothesis (May 10, 2015 10:30 PM), *available at* http://m.e-m-h.org/ClJM.pdf.

60. *Id.* at 5-6 ("Semi-strong efficiency of markets requires the existence of market analysts who are not only financial economists able to comprehend implications of vast financial information, but also macroeconomists, experts adept at understanding processes in product and input markets").

61. Fama, *supra* note 56.

62. *Cf.* Ralston Purina *supra* note 20 (not discussing the manner in which information must be reflected).

63. SEC, OFFICE OF INSPECTOR GENERAL, REPORT NO. 459, REGULATION D EXEMPTION PROCESS 2 n.18 (2009). Additionally the market for private placements may dwarf that of registered securities. Thomson Reuters estimated that over $1.7 trillion worth of securities were raised by private placement from 2005 to 2009. https://www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589956792, slide 10. In contrast, the SEC reported approximately $699 billion of securities registered during that time. 2009 U.S. Sec. & Exch. Comm'n Performance and Accountability Report at 42 fig.2.23 (2009), available at https://.sec.gov/about/secpar/secpar2009.pdf.

64. 17 C.F.R. § 230.502(b) (2013).

offering involving only accredited investors, no disclosure is necessary.[65] To make up for this short fall, large investors negotiate for disclosure.[66] However, due to the private nature of the transaction, there may be disparities in information available to each particular investor.

Additionally, since private placement shares are restricted,[67] the efficient market hypothesis does not always hold true. New public information is not reflected into the price of the security. An investor must either rely on their own savvy, or the savvy of a price setter to procure an accurate price.

Additionally, because information flow is less regulated and private companies are generally less mature then public companies, private markets are generally considered high-risk investments.[68] Therefore, even if companies disclose their historical information, the relatively small amount of information may not produce an accurate forecast of their future performance.[69]

Securities procured through private placements may also be virtually impossible to sell.[70] For issuers that rely on Rule 4(a)(2) to complete an exempt offering, purchasers are required to demonstrate investment intent if they seek to engage in selling securities.[71] Courts use a two-year period to presume that a security has come to rest and was purchased with investment intent. Investors can sell securities prior to that, but they bear the burden of establishing a "change in circumstance."[72] Additionally, Regulation D offerings allow securities to be traded if they are registered or qualify for another exemption.[73] The most common exemptions are Rule 144 and Rule 144A. Rule 144 imposes holding and information periods for issuers that may last one year.[74] While Rule 144A does not require any

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65. *Id.*

66. Patrick Simpson, *Tips For Conducting A Private Placement*, LAW360 (July 02, 2013), http://www.law360.com/articles/453476/tips-for-conducting-a-private-placement (discussing private disclosures in the form of Private Placement Memorandums).

67. 17 C.F.R. § 230.502(d).

68. SEC, Investor Bulletin on Private Placements Under Regulation D (Sept. 24, 2014), http://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

69. *See Discounted Cash Flow (DCF) Analysis*, MACABCUS (May 12, 2015 12:30 PM), http://macabacus.com/valuation/dcf/overview; *See also Step 1—Project Free Cash Flow*, STOCKS 400 (May 12, 2015 1:00 PM), http://news.morningstar.com/classroom2/course.asp?docId=145102&page=2&CN= (This is under the assumption that investors are using a Discounted Future Cash Flow analysis. While the method is used to predict future cash flows, many assumptions of future cash flows can be derived from historical data. The larger the data pool, the more effective the analysis.).

70. SEC Investor Bulletin, *supra* note 68.

71. CHOI & PRICHARD, *supra* note 57.

72. *Id*.

73. 17 C.F.R. § 230.502(d).

74. 17 C.F.R § 230.144(d).

holding period, sales can only occur to institutional investors.[75] The difference between disclosure and accurate pricing may be the need for different types of participates in the private and public markets.

III. Problems with the Accredited Investor Standard

In recent years the accredited investor standard has gained substantial attention. Specifically, after the great recession in 2008, where a large amount of individuals lost substantial sums, Congress enacted the Dodd-Frank Act. Under Section 413(a) of the Act, Congress authorized the SEC to review the accredited investor definition as it applied to individuals.[76] The legislation required the SEC to remove primary residence from the net worth standard in an effort to create a more accurate standard.[77] Additionally, the obligation to review the standard was renewed every four years.[78] The regulation has offered an opportunity to discuss the costs and benefits of the current standard.

There are both merits and failures of the current accredited investor definition. Although there are some common defenses for the current standard, wealth is a poor proxy for investor sophistication because of (a) the different methods of wealth accumulation, and (b) instances where institutional investors failed to properly evaluate market risks. I will demonstrate how the complexity of the current financial market requires more expert market participants and how even sophisticated investors may fall prey to behavioral biases. Finally, I will discuss how these failures can have an especially strong impact on certain classes of individuals.

A. *Common Defenses to the Accredited Investor Standard*

The defense of the accredited investor standard has generally centered around three different arguments. First, individuals with high net worth or annual income have a greater ability to bear the loss of their investment.[79] Second, individuals with wealth, although they may not have financial sophistication, are able to employ sophisticated representatives on their behalf.[80] Finally, there is a general fear that changing the accredited investor standard will curb capital formation.[81] This last concern requires some

75. Specifically, sales must occur to Qualified Institutional Buyers, which is defined to include large insurance or investment companies, dealers, or banks. 17 C.F.R 230.144A.

76. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §413(a), 124 Stat. 1376, 1577 (2010); *see generally* Net Worth Standard For Accredited Investor, 76 Fed. Reg. 5307 (proposed Jan. 31, 2011).

77. Dodd-Frank, *supra* note 74.

78. *Id*.

79. SEC, Investor Bulletin on Accredited Investors (Sept. 23, 2013), http://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf.

80. *See* Greg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 Nw. U. L. Rev. 285, 294 (2012).

81. *See* So-Yeon Lee, Note, *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 Rev. Banking & Fin. L. 987, 991 (2012).

elaboration. Issuing private placements and side stepping federal regulations offers a reduction in transaction costs to obtain capital.[82] Thus, issuers are able to make more efficient use of their capital by deploying more of it to the building of their business.[83]

B. *Failure of Wealth Based Tests in Determining Sophistication*

The accredited investor standard, which polices entry into the private markets, is fraught with issues when it comes to protecting the individual investor. It is misaligned with the Supreme Court's original intention for the private markets to include only sophisticated parties. Although Regulation D, which includes the accredited investor standard, was promulgated with the objective of providing a clear standard to determine if a purchaser has the "sufficient knowledge and experience in financial and business matters" to evaluate the risks of private markets,[84] it only evaluates financial metrics.[85] While it is possible that some correlation exists, wealth ultimately serves as a poor proxy for sophistication.[86]

1. Diverse Methods of Wealth Accumulation

The assumption underlying the argument that high net worth individuals have procured some amount of financial literacy proves faulty when examining certain ways in which wealth is accumulated. First, wealth may be accumulated by windfall, like through inheritance or games of chance.[87] Building wealth in this manner requires little more than being in the right situation. More realistically, wealth building may be an incremental process.[88] An owner of an auto repair shop may, over the course of their working life, save enough money to accumulate a retirement nest egg of $1 million. However, this process does not necessarily equip the mechanic to evaluate the risks presented by highly complex assets in the private market.

2. Institutional Investor Failures

Even when examining institutional investors, there is evidence that they may not always fully comprehend the risks of particular investments. Gregg Oguss offers an insightful study of instances where this is the case.[89]

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82. *Id.*

83. Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation,* 47 OKLA. L. REV. 291, 299-300 (1994).

84. SEC, Fast Answers, RULE 506 OF REGULATION D, http://www.sec.gov/answers/rule506.htm (last modified Oct. 6, 2014).

85. 17 C.F.R 230.501(a)(5)-(6).

86. *See generally* Oguss, *supra* note 78.

87. *See* Lee, *supra* note 79 at 991.

88. *See* Net Worth and Asset Ownership of Households: 2011, U.S. CENSUS BUREAU *available at* http://www.census.gov/people/wealth/files/Wealth_Tables_2011.xlsx (showing high proportions of IRA savings).

89. *See* Oguss, *supra* note 78, at 301-10.

The first instance centered on the derivative woes of the 1990s. During that time, several large institutional investors, such as Procter and Gamble ("P&G"), lost huge amounts of capital on interest-rate swap vehicles.[90] Upon closer examination, Oguss concluded that these investors placed bets on positions that they did not completely comprehend.[91]

In 1993 P&G approached Bankers Trust to discuss products that would help it take advantage of interest rate movements.[92] Later that same year, paying double what they initially planned, P&G bought leveraged derivate products for $200 million.[93] Since derivative securities experience higher fluctuations, they have much greater downside potential compared to regular derivatives.[94] Ultimately, the transaction's upside, when compared to other possibilities, was relatively minuscule.[95] Additionally, when the Federal Reserve announced that short-term interest rates would rise, P&G, contradictory to conventional thinking, increased their investments in the product with the hope that rates would change.[96] Ultimately, P&G settled with Bankers Trust, partly due to recordings where bankers gloated that their customers knew little about the risks of their transactions.[97]

In the 2000s Collateralized Debt Obligations ("CDOs") rose in popularity as an investment product. Though the investment craze in CDOs is notorious for its effect on housing prices, there were several institutional investors that suffered losses.[98] In 2007 IKB Deutsche Industriebank had been purchasing CDOs backed by prime and subprime mortgages. Goldman Sachs, with the aid of Paulson & Co. as well as ACA Management, created and marketed CDOs called ABACUS 2007-AC1.[99] Nine months after IKB's $150 million investment the house market collapsed and the investment was essentially worthless.[100] Suggesting an inability to properly evaluate the risks of these speculative investments, Goldman

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90. *See* Lawrence Malkin, *Procter & Gamble's Tale of Derivatives Woe*, Int'l Herald Trib., Apr. 14, 1994, at 9.

91. Oguss, *supra* note 80, at 303.

92. Carol J. Loomis, *Untangling the Derivatives Mess*, Fortune, Mar. 20, 1995, at 50, 62.

93. *Id*. at 64.

94. Kelley Holland & Linda Himelstein, *The Bankers Trust Tapes*, Bus. Wk., at 106, 110 (Oct. 16, 1995).

95. *See* Loomis, *supra* note 92, at 64.

96. *Id*.

97. *See generally* Holland & Himelstein, *supra* note 94, at 108.

98. *See* Marc Pitzke, *Wall Street vs. Washington: Goldman Sachs Goes on the Offensive*, Spiegel Online (Apr. 22, 2010, 3:19 PM), http:// www.spiegel.de/international/business/0,1518, 690527,00.html.

99. *See* Philip Whalen & Kara Tan Bhala, *Goldman Sachs and the ABACUS Deal*, Seven Pillars Inst. for Global Fin. & Ethics, http://sevenpillarsinstitute.org/case-studies/goldman-sachs-and-the-abacus-deal.

100. Gregory Corcoran, *SEC v. Goldman: Meet One Abacus Investor*, Wall St. J. Deal J. (Apr. 16, 2010, 12:26 PM), http://blogs.wsj.com/deals/2010/04/16/sec-v-goldman-meet-one-abacus-investor/.

Sachs lost more than $100 million in the investment, which wiped out their $15 million fee.[101]

Additionally, both the Enron[102] and Madoff scandals offer caution to those who believe that wealth is a strong proxy for good investment decision-making. Specifically, the Madoff scandal implicated a remarkable lack of diligence by sophisticated investors.[103] Some investors conducted, at most, pro forma diligence on the investment program before sending large sums of funds to be invested.[104] Decisions by Madoff investors could be explained by behavioral economic factors such as sunk cost fallacy, the endowment effect, and hyperbolic discounting.[105]

3. Behavioral Biases May Exist even in Sophisticated Investors

As discussed earlier, the basis for the accredited investor definition is that sophisticated investors are able to fend for themselves. Even assuming that wealth is an accurate proxy for financial sophistication, studies suggest that these investors may not always be able to fend for themselves. Illustrative of this is the disposition effect, which is characterized by a decreased propensity to realize losses and an increased propensity to realize gains.[106]

In a study regarding investment behavior in Finland, it was shown that disposition effect was found in several investor types, including non-financial corporations, financial and insurances institutions, as well as government and non-profit intuitions.[107] The phenomenon is known to affect sophisticated investors such as futures traders, professional account managers, and proprietary stock traders.[108]

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101. Oguss, *supra* note 78, at 306.

102. Frank A. Walak, *Policy Brief: Making Sense of the Enron Nonsense*, STANFORD INSTITUTE FOR ECON POLICY RESEARCH, 1 (2002) http://web.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_may02.pdf (stating that "[e]ven the most sophisticated market watchers were unable to divine Enron's Profit positions from its financial statements.").

103. *See* Smith, *supra* note 39 at 253.

104. *See* Madoff's Victims, WALL ST. J. (Mar. 6, 2009), http://s.wsj.net/public/resources/documents/st_madoff_victims20081215.html.

105. Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1046 (2009).

106. Lei Feng & Mark S. Seasholes, *Do Investor Sophistication and Trading Experience Eliminate Behavioral Biases in Financial Markets*, 9 REV. OF FINANCE 305, 305 (2005) *available at* http://www.seasholes.com/files/Paper_Feng_Seasholes_2005_RoF.pdf.

107. Mark Grinblatt & Matti Keloharju, *What Makes Investors Trade?*, 56 J. OF FIN. 589, 589–616 (2001).

108. Ryan Garvey & Anthony Murphy, *Are Professional Traders Too Slow to Realize Their Losses?*, 60 FIN. ANALYST J., July/Aug. 2004 at 35–43 (stating that US proprietary traders "realized their winning trades at a much faster rate their losing trades"); Joshua D. Coval & Tyler Shumway, *Do Behavioral Biases Affect Prices?* 60(1) J. OF FIN. 1, 1–34 (2004) (showing that proprietary trader of T-Bpnf futures "appear highly loss adverse, regularly assuming above-average afternoon risks to recover from morning losses"); Paul G.J. O'Connell & Melvyn Teo, *Prospect Theory and Institutional Investors* (Working Paper, 2003), http://

C. *Failure of the Current Standard in Assessing Bearing Loss of Investments*

According to the SEC, a principle purpose of the accredited investor definition is for individuals to bear the loss of their investments.[109] Unfortunately, the current standard does not do an adequate job of pacifying this concern. The standard measures loss tolerance by two metrics – net worth, and annual income.[110] An individual's net worth is calculated by the difference between their total assets and total liabilities.[111] The measure does not pay any regard to the liquidity of an individual's assets.[112] The oversight is significant in several regards. For instance, an individual who makes investments in liquid assets, which subsequently fail, may be forced to sell his or her positions in order to meet capital needs. However, sales of illiquid assets include a liquidity discount to compensate the purchaser for their inability to make resales.[113]

The gross income test for individual investors fails for similar reasons. The standard simply looks at an individual's income without regard to expenses that they may have.[114] As an illustration, based on the current standard, sixth-year associates at large law firms would be able to participate in the private market, even though many would be burdened with a high amount of loan repayments.[115] By failing to measure expenses and debts, the current standard allows for situations where an investor could be overly leveraged and may not be able to absorb the loss of highly risky private placement investments.[116]

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faculty.haas.berkeley.edu/lyons/Oconnell%20Teo%20prospect%20theory.pdf (finding that institutional money managers from State Street "aggressively reduce risk in the wake of losses, but only mildly increase risk in the wake of gains).

109. Investor Bulletin, *supra* note 77.

110. 17 C.F.R. § 230.501(a).

111. Investor Bulletin, *supra* note 77.

112. Jeremy Vohwinkle, *How to Calculate Your Net Worth,* About Money, http://financialplan.about.com/od/personalfinance/ht/networthhowto.htm (last visited May 10, 2015).

113. Alvin L. Arnold, Real Estate Investor's Deskbook § 2:12(5) (Warren, Gorham, & Lamont eds., 3d ed. 1994).

114. Lee, *supra* note 79, at 993.

115. *See 2015 LawCrossing Salary Survey Of Lawyer Salaries In Best Law Firms*, LawCrossing, http://www.lawcrossing.com/article/900043256/2015-LawCrossing-Salary-Survey-of-Lawyer-Salaries-in-Best-Law-Firms/ (last visited May 10, 2015) (reviewing the current lock step figures, a sixth year associate would be making $250,000 and would have earned over $200,000 in each of the two previous years).

116. Law School graduates from the top fourteen law schools as ranked by US News, on average, all graduate with over $100,000 in law school debt, with several schools graduating students with over $150,000 in debt. *Which Law School Graduates Have the Most Debt*, U.S. News & World Report, http://money.cnn.com/2014/07/15/pf/jobs/lawyer-salaries/ (discussing declining income and rising debt levels) (last visited May 10, 2015).

D. *Unprotected Class: Elderly*

The problem with the current accredited investor standard is not just that it may be under-inclusive in theory, it also leaves a very large class of individuals unprotected. The United States is going through an aging of its population as the baby boomer generation reaches retirement age. A total of approximately 43 million individuals were of retirement age by 2012.[117] By 2020, that number will balloon to almost fifty six million individuals, comprising almost sixteen percent of our total population.[118] The concern here is not merely the size of this group, but the fact that they are more likely to qualify for the financial metrics of the accredited investor standard combined with their overall poor financial literacy.

The elderly population, as a whole, is amongst the most well-off classes in the United States. Though specific statistics that qualify this group for the accredited investor standard are difficult to come by, proxies are available. A recent study by the U.S. Census Bureau found that the mean net worth for individuals age 65 and above was over $650,000.[119] Breaking this statistic down even further, the mean net worth for individuals between the ages of 65 and 69, and 70 and 74, was approximately $820,000 and $860,000, respectively.[120] Even excluding the equity in their homes, individuals over the age of 65 maintained a mean net worth of over $500,000.[121] While averages must be looked at cautiously,[122] it should be noted that over 20 percent of individuals who were age 65 and above had a net worth of over $500,000.[123] Importantly, large portions of the net worth for these individuals were comprised of IRA accounts, as well as stocks and mutual funds.[124] This may indicate retirement planning and greater dependence on these assets for sustainability.

Comparatively, no age group that was age 54 and younger reached $300,000 in mean net worth.[125] Excluding home equity, the highest group, those between the ages of 45 and 54, had a mean net worth of approxi-

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117. Jennifer Ortman, Victoria Velkoff & Howard Hogan, *An Aging Nation: The Older Population in the United States*, U.S. Census Bureau 1 (May 2014), https://www.census.gov/prod/2014pubs/p25-1140.pdf.

118. *Id.*

119. *Net Worth and Asset Ownership of Households: 2011*, U.S. Census Bureau, http://www.census.gov/people/wealth/files/Wealth_Tables_2011.xlsx (noting also that individuals approaching retirement age, those between 55 and 64, had sizable net worth as well at an average of approximately $470,000, and $350,000 excluding home equity).

120. *Id*.

121. *Id*.

122. The median net worth of individuals in the 65 and over bracket was approximately $170,000. Individuals who were 65 to 69 and 70 to 74 had net worth of approximately $195,000 and $180,000, respectively. *Id.*

123. *Id*.

124. *Id*.

125. *Id*.

mately $200,000.[126] Furthermore, only about 14 percent of individuals between the ages of 45 and 54 had a net worth over $500,000, with a significant drop off in younger age groups.[127]

It is not simply that the older generation is more well off then earlier generations. Research indicates that they are among the most poorly educated classes in terms of financial literacy.[128] A recent study measuring the financial literacy of individuals in the United States found that less than 30 percent of individuals age 65 and over tested positively, and were the second most poorly scoring group behind individuals age 36 and younger.[129] In a more focused study, it was found that older generations are generally not financially sophisticated.[130] Individuals in the study lacked understanding of key concepts to investment decision-making inducement, risk diversification, asset valuation, and the effect of investment fees.[131] The authors forecasted bleak implications on older generations in an environment that allowed for greater responsibility of fund management.[132]

E. *Complexity of Financial Products*

There is increased attention on the complexity of ever evolving financial products, and the investment community's ability to properly evaluate them. The examples regarding the derivatives and CDO crises are just one of several instances. The Certified Financial Planner Board of Standards cited "increased complexity of financial products and services . . . in the last 30 years" in recommending increased reliance on investor sophistication rather than net worth.[133] The CFP suggested that the intricacies of these products made it difficult for average investors to make informed decisions.[134]

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126. *Id*.

127. *Id*.

128. Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52 J. of Econ. Literature 5, 21–25 (2014), http://www.umass.edu/preferen/You%20Must%20Read%20This/Financial%20Literacy%20JEP%202014.pdf.

129. *Id.* at 10–18 (explaining that the study was predicated on three questions measuring knowledge of compound interest, inflation, and stock risk. Positive results indicated answering all three questions correctly).

130. *See* Annamaria Lusardi, Olivia S. Mitchell, & Vilsa Curto, *Financial Literacy and Financial Sophistication in the Older Population*, 14 J. of Pension Econ. & Fin 347, 364 (2014).

131. *Id*.

132. *Id.* at 348.

133. Jim Hamilton, *Certified Financial Planners Urge SEC to Make Accredited Investors More Sophisticated*, SEC Today (Jan. 6, 2015), 2015 WL 67027, https://a.next.westlaw.com/Document/I7f4b2aa5965011e498db8b09b4f043e0/View/FullText.html?transitionType=UniqueDocItem&contextData=(sc.Default)&userEnteredCitation=2015+WL+67027.

134. *Id*.

IV. Evaluations For a New Standard

Under the assumption that strengthening small businesses would boost the economy during the recession, Congress passed the JOBS Act in a rare bipartisan effort. Among other changes, the Act instructed Congress 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" of Regulation D.[135] This change allows issuers to target individuals who would not normally consider private placements, and are poorly equipped to deal with its risks.

Recognizing the issues presented by the accredited investor standard do not solve the problem, there are still opposing viewpoints as to what should be favored when designing a new standard. Some proponents seek to create a test that evaluates investor sophistication above all else.[136] On the other hand, there are individuals that believe adjusting the current standard could have poor effects on capital formation.[137] As discussed, the SEC has taken the position that one of the purposes of the standard is to evaluate whether individuals have the financial ability to bear the loss of their investment.[138] This section argues that both investor sophistication, as well as the ability to bear financial loss, are both important considerations in designing a new standard.

A. *The Need for Investor Sophistication*

As stated earlier, the presumption for investors participating in private placements is that they can fend for themselves.[139] In place of registration, the Act substituted private monitoring of disclosures.[140] Sophisticated investors virtually functioned as proxies for federal regulatory authorities in deciphering material information.[141]

For this proxy status to be maintained, investors must have "sufficient skills, resources, or bargaining strength" in relation to the issuers to extract proper information.[142] Knowledgeable consumers who make informed choices make it difficult for unfair and deceptive practices to take

135. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–15 (2012).

136. Hamilton, *supra* note 132.

137. U.S. Gov't Accountability Office, Abstract, *supra* note 27 (stating that "association of angel investors—accredited investors who invest in start-up companies—told GAO that they would be resistant to increased thresholds because it would decrease the number of eligible investors").

138. Investor Bulletin, *supra* note 77.

139. SEC v. Ralson Purina Co., 346 U.S. 119, 125 (1953).

140. *See* Smith, *supra* note 39, at 243.

141. *See id*.

142. *See* Marianne A. Hilgert, Jeanne M. Hogarth, & Sondra G. Beverly, *Household Financial Management: The Connection between Knowledge and Behavior*, 320-321 Fed. Reserve Bulletin, July 2003, http://www.federalreserve.gov/pubs/bulletin/2003/0703lead.pdf.

place in a market.[143] Due to this sophistication, it can be argued that investors who participate in private offerings accept the risks accompanied by lack of standard disclosures, and transparency in private markets.[144]

A core factor associated with sophistication is financial literacy.[145] Although there are some arguments to the contrary, studies have demonstrated that there is a substantial link between an individual's decision-making and financial stability.[146] Studies have also suggested that there is a link between financial literacy and day-to-day investment decisions.[147]

Additionally, financial acumen has been linked to precautionary savings.[148] This becomes especially important when considering that the SEC itself acknowledges that "[o]ne principal purpose of the accredited investor concept is to identify persons who can bear the economic risk of investing in these unregistered securities.[149] Finally, financial literacy is also related to overall financial health. Less financially literate individuals are more likely to have costly mortgages, and may end up accumulating less wealth.[150] Therefore, if the accredited investor standard functions correctly, individuals participating in the private placement markets should be adequately protected.

B. *The Argument for Bearing Loss of Investments*

Perhaps the most convincing argument for why an accredited investor standard should account for an individual's ability to bear the loss of their investment is that investor sophistication does little to guarantee proper decision making. That may not be an issue where an individual is young and can recoup a large portion if not all of their losses. However, elderly individuals do not have such a luxury.[151]

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143. *Id.* at 309.

144. *See* SEC v. Ralson Purina Co., 346 U.S. 119, 125 (1953) (stating that "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

145. Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 905 (5th Cir. 1977) (stating that ". . . [t]he investment sophistication of the offeree assumes added importance, for it is important that he could have been expected to ask the right questions and seek out the relevant information.").

146. *See generally* Lusardi & Mitchell, *supra* note 127.

147. See Hilgert, Hogarth, & Beverly, *supra* note 141, at 317–18 (showing that households with poor investment scores "had lower overall financial knowledge scores and lower investment knowledge scores . . . than those who were classified as medium or high on the investment index.").

148. Carlo de Bassa Scheresberg, *Financial Literacy and Financial Behavior among Young Adults: Evidence and Implications*, 6 NUMERACY, no. 2, 2013, at 16, *http://scholarcommons.usf.edu/cgi/viewcontent.cgi?article=1138&context=numeracy* ("[T]hat financial literacy was negatively correlated with using high cost of borrowing methods while positively correlated with have precautionary savings and planning for requirement.").

149. Investor Bulletin, *supra* note 77.

150. *See* Lusardi & Mitchell, *supra* note 127, at 22-23.

151. Note, Larissa Lee, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 UTAH L. REV. 369, 385 (2014).

In addition to the institutional failures above, it is possible that financial experts do not make better investment decisions than less sophisticated investors.[152] When measuring the decision making of experts in relation to their own portfolio, managers do not show a superior ability to select securities.[153] Additionally, while managers, perhaps recognizing their own limitations, invest a greater amount in mutual funds they still exhibit similar portfolio concentration as the average investor.[154]

It must be noted that if an individual loses a substantial portion of their assets, their costs are not simply bore by those investors. Systemic investment failures caused by poor decision makers can affect capital formation as a whole. In the years after the Great Recession net private investments collapsed substantially.[155] Additionally, investors who tapped out of their savings due to complete losses may actually require assistance through government aid programs, indirectly imputing costs to taxpayers.

V. A More Precise Standard

As discussed above, the accredited investor standard has several issues - both in testing investor sophistication and in evaluating an individual's ability to bear the loss of their investment. As shown by the need for crowdfunding implementation, the current rule also inhibits capital formation.[156] Fortunately, due to the Dodd-Frank mandate, there is opportunity to consider new methods to align the accredited standard to more appropriately protect investors and encourage capital formation.

A. *Sophistication*

The primary purpose for the accredited investor definition should still be centered on determining investor sophistication. A more appropriate standard would focus on investor credentials. For instance, investors who are licensed CFAs and CPAs can be presumed to have the requisite financial understanding to invest independently. Those individuals who are not independently licensed should be required to pass an investor sophistication test.[157] Finally, those individuals who are not able to pass the investor

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152. Andriy Bodnaruk & Andrei Simonov, *Do Financial Experts Make Better Investment Decisions?*, J. of Fin. Intermediation (forthcoming Oct. 2014) (manuscript at 2), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2506988.

153. *Id*.

154. *Id*.

155. *See* Gerald Friedman, *Collapsing Investment and the Great Recession*, Dollars & Sense (July/Aug. 2013), http://www.dollarsandsense.org/archives/2013/0713friedman.html.

156. *See* Chris Tyrrell, *SEC OKs Equity Crowdfunding, so Anyone Can Invest in Private Companies*, TechCruch (Mar. 27, 2015), http://techcrunch.com/2015/03/27/sec-rule-change-gives-startups-an-a-for-capital-formation/.

157. *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 Calif. L. Rev. 279, 310-18 (2000) (discussing different types of licensing for different levels of investor classes).

sophistication test should be required to seek representation from a qualified individual when entering the private market.

B. *Wealth Requirement*

The utility of a wealth requirement to entering the public market is that it restricts investments to those individuals who are able to bear the loss of their funds. However, imposing a strict income or net assets cut-off proves to be inflexible and discouraging of capital formation. To address these issues, the SEC should recognize a sliding scale approach similar to that required for crowdfunding under the JOBS Act.[158] To encourage diversification, the regulation should place a cap on investments in any particular company. However, recognizing that diversification is limited in the private markets,[159] there should also be limits on total investments by an individual.[160]

C. *Annual Income and Net Assets Definitions*

In order to align the accredited investor standard to individuals who are able to bear the loss of their investment, further clarification to the definition of annual income and net assets is necessary. Net assets, for example, should not only exclude primary residence, but illiquid assets generally.[161] If such assets are included, they should be discounted to reflect their value in a rushed sale. Finally, recognizing that annual income fails to measure an individual's lifestyle,[162] discretionary income should be utilized instead.[163]

D. *Leverage*

An increase in leverage will generally have an adverse effect on an investor's ability to bear the loss of their funds. As such, the SEC should also limit an investor's ability to leverage their assets when investing. For

158. Generally, individual investments during a 12-month period are limited to the greater of $2,000 or 5 percent of annual income or net worth of the investor, if such investor's annual income or net worth is less than $100,000, and to 10 percent of annual income or net worth if the investor's income or net worth exceeds $100,000. *See* 15 U.S.C. § 77d (2015).

159. *See Venture Capital*, U.S. Small Business Administration (last visited May 11, 2015), https://www.sba.gov/content/venture-capital (expressing the proposition that venture capital funding focuses on young companies that are considered riskier investments).

160. In contrast, the current JOBS Act provisions allow for unlimited investments. *See* Lee, *supra* note 150, at 371.

161. *See* Lee, *supra* note 79, at 992-94 (explaining that the accredited investor standard does not accurately reflect an investor's true discretionary income when it includes illiquid assets).

162. *Id.* at 993 (explaining that because the gross income standard "fails to consider the full extent of an individual's expenses, an investor may have sufficient adjusted gross income, but may not have the requisite funds to absorb financial losses.").

163. *Id.* at 994-95 ("The discretionary income standard is a better financial measure of determining whether a particular investor can afford to make risky investments because it quantifies his or her capacity to absorb financial losses.").

instance, it may be appropriate to prohibit leveraged investments generally, but to allow it for institutional investors.

VI. Conclusion

The current standard for an accredited investor, although having the virtue of clarity and ease of implementation, fails at protecting individuals in the private market. Utilization of wealth is a poor proxy for investor sophistication. The SEC should use the Dodd-Frank mandate to create a more tailored accredited investor standard. Given that participation in the private market has evolved since *Ralston Purina,* the SEC should balance capital formation, loss bearing, and investor sophistication as key policy concerns in reviewing the current standard.