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From: Andrew Vollmer
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In response to Sen. Toomey's request, here are several ideas for simplifying securities regulations to increase economic growth and job creation. See the two attachments and:

Make It Easy for Startups to Sell Stock, The Bridge (September 21, 2020) (a Mercatus publication), https://www.mercatus.org/bridge/commentary/make-it-easy-startups-sell-stock.

Abandon the Concept of Accredited Investors in Private Securities Offerings

Andrew N. Vollmer

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Abstract

Accredited investors as defined in the Securities and Exchange Commission's Regulation D occupy a favored spot in the world of federal securities law and may participate in investment opportunities not available to other investors. The Securities and Exchange Commission (SEC) views accredited investors as sophisticated and able to fend for themselves in making securities investments without the need for the main disclosure protections in the Securities Act.

Closer consideration of the accredited investor category raises questions about its continued vitality. It provides some benefits, but reasons for dispensing with the line between accredited and non-accredited investors are extremely strong. In particular, the SEC's rationale for the category is deeply flawed, and many of the components of the category fail to effectuate even the flawed rationale.

A better regulatory approach would be to get rid of the category and rely on a short set of mandatory disclosures. This would guarantee the supply of essential information rather than depend on the voluntary choices of issuers and speculative assumptions about investor sophistication and access to information. It would also have several other advantages and would not add significant costs because issuers overwhelmingly already prepare and provide disclosure to accredited investors.

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Abandon the Concept of Accredited Investors in Private Securities Offerings

Andrew N. Vollmer

Accredited investors occupy a favored spot in the world of federal securities law. Under the terms of a regulation of the Securities and Exchange Commission (SEC), Rule 506 of Regulation D,[1] accredited investors may participate in investment opportunities not available to other investors, such as investments in fast-growing high-technology companies that have not yet sold securities to the public and certain hedge funds and venture capital funds. Rule 506 is a private securities offering exempt from the elaborate registration and disclosure requirements in the Securities Act. A company using it may sell securities of an unlimited dollar amount to an unlimited number of accredited investors, may use general advertising to reach them, and has no legal obligation to make any disclosures to them.

Accredited investors receive this treatment because the SEC views them as sophisticated and able to fend for themselves in making securities investments without the need for the main disclosure protections in the Securities Act.[2] Many types of market participants within the definition of accredited investors certainly satisfy this standard, such as broker-dealers, registered investment companies, banks, and insurance companies, but many types do not do so in a consistent way, such as a corporation or nonprofit organization with total assets over $5 million. Thus, the SEC has misapplied the standard and, along the way, has misinterpreted it.

The purpose of this paper is to take a closer look at the history and basis for the accredited investor definition in Rule 506 transactions. It discusses the benefits of retaining the

[1] Regulation D includes Rules 500 through 508. 17 C.F.R. §§ 230.500–230.508.
[2] *See* SEC, Amending the "Accredited Investor" Definition, Securities Act Rel. No. 33-10824, at 5-6 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf ("Adopting Release") (adopting release).

accredited investor category and then describes several reasons for not keeping it. The reasons for dispensing with the line between accredited and non-accredited investors are extremely strong. In particular, as explored in detail, the SEC's rationale for the accredited investor category is deeply flawed, and many of the components of the category fail to effectuate even the flawed rationale.[3] This discussion goes further than earlier criticisms of the concept of accredited investors.

Part of the discussion describes two surprising revelations the SEC made in its explanation of new amendments to the definition of accredited investors.[4] Breaking from its long-standing position that a natural person's wealth is a reliable guide to financial sophistication, the SEC fessed up and recognized that "higher income or net worth does not necessarily correlate to a higher level of financial sophistication" in the case of individuals.[5] The second jolt was that the SEC refused to apply the leading precedent in the area, *SEC v. Ralston Purina Co.*,[6] which established the doctrinal predecessor to the concept of accredited investors.[7]

The re-examination suggests that a better regulatory approach would be to rely on a minimum level of mandatory disclosures in private offerings and repeal the accredited investor category. This would guarantee the supply of essential information rather than rely on the voluntary choices of issuers and speculative assumptions about investor sophistication and access to information. It would be more consistent with the leading judicial decisions of the relevant registration exemption. This approach would also broaden the sources of capital to

[3] This paper addresses only the utility of the accredited investor category for Rule 506 transactions and does not address the use of the accredited investor concept in other parts of the securities laws. *See* SEC, Amending the "Accredited Investor" Definition, 85 Fed. Reg. 2574, 2598–99 (Jan. 15, 2020) ("Proposing Release") (proposing release) (describing the use of the accredited investor definition in other areas of the federal securities laws).
[4] See Adopting Release, *supra* note 2.
[5] Adopting Release, *supra* note 2, at 146; see text accompanying notes 75–81.
[6] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[7] See text accompanying notes 61–63.

include non-accredited investors. A system of mandatory disclosure would only negligibly increase regulatory burdens and costs because issuers overwhelmingly already prepare and provide disclosures to accredited investors.[8]

To keep private offerings attractive and efficient, the mandatory disclosures do not need to be and should not be as lengthy as a prospectus in a registered offering or an annual report of a reporting company. The disclosure needs to provide essential information about a company and the securities being sold. The offering statement for a crowdfunding transaction, with some modifications, should be the model.

As background, Part I of this paper briefly traces the history of the SEC rules that allowed sales of securities to accredited investors with no mandatory disclosure. Part II then discusses whether the distinction between accredited and non-accredited investors remains useful or should be eliminated and considers the benefits and costs of the accredited investor category. It shows that a variety of social costs and problems with the accredited investor definition substantially outweigh the benefits. Part III describes the main features of a private offering safe harbor that dispenses with the accredited investor category and returns to the original conception of the private offering exemption with reliance on actual disclosures. Part IV concludes.

I. History of the Accredited Investor Category

The definition of "accredited investor" was originally developed to implement the private offering exemption in section 4(a)(2) of the Securities Act but over time has moved further and

[8] *See* Andrew N. Vollmer, *Evidence on the Use of Disclosure Documents in Private Securities Offerings to Accredited Investors* (Mercatus Center at George Mason University, Arlington, Va., Working Paper, 2020).

further away from the original conception. The evolution has led to a definition prompting many criticisms. This Part reviews these developments and the essential role of mandatory disclosure.[9]

A. The Disclosure Regime in the Securities Act

The heart of the Securities Act of 1933 was mandatory disclosure by a person selling securities. Section 5 required a person to have a registration statement in effect to sell a security, and section 7 required the registration statement to have detailed and lengthy disclosures about the company issuing the securities and the securities themselves.[10]

The Securities Act did not restrict the potential buyers in a registered offering. Any person could buy. Under the Securities Act, the legal obligation of the issuer was to provide truthful and complete disclosure. If investors had full and true information about a company and its securities, they could make up their own minds about whether to buy. The law did not limit potential investors to landowners, financial institutions, or natural persons with a large net worth or with the ability to sustain the loss of the investment.[11] The law did not limit the amount of money a person could invest.

The federal securities laws were to increase the flow of accurate information and not to protect investors in a paternalistic way from potentially bad investments. Investors were free to

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[9] Much of the following history of the statutory private offering exemption and the SEC regulations leading to Regulation D is from a comment I submitted to the SEC in response to the Concept Release. Andrew N. Vollmer, Public Interest Comment on SEC Concept Release on Harmonizing Private Securities Offering Exemptions, at 5–9 (Mercatus Center at George Mason University, Sept. 24, 2019), https://www.mercatus.org/system/files/vollmer-securities-offering-exemptions-mercatus-v1.pdf. Other sources for the developments include Proposing Release, *supra* note 3, at 2577–78; SEC, Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460, 30,479–80 (June 26, 2019) ("Concept Release"); SEC Staff, Report on the Review of the Definition of "Accredited Investor" 8–21 (2015); Christopher R. Zimmerman, Note, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 NW. U. L. REV. 507, 513–19 (2019); Thaya Brook Knight, *Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors* 4–9 (Policy Analysis No. 833, Cato Institute, Washington, D.C., Feb. 9, 2018).

[10] *See* 15 U.S.C. §§ 77e, 77g.

[11] Knight, *supra* note 9, at 4 (anyone can buy in the public markets).

put their own resources at risk. They could buy securities in a company that looked risky or that proved to be successful or not successful. The Act respected the liberty and personal autonomy of potential investors. Investor protection was the spirit of the federal securities laws, but it was protection consistent with the country's history and tradition of freedom and self-reliance.[12]

B. The Statutory Private Offering Exemption

The elaborate process for a registered public offering did not apply in certain circumstances. In sections 3 and 4 of the Act, Congress exempted certain types of securities and transactions from the registration process. The House report accompanying one of the main predecessors of the Act said the bill "carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote."[13]

One of the exemptions, now in section 4(a)(2), was for "transactions by an issuer not involving any public offering," often called the private offering exemption. Two main judicial decisions interpreted the exemption.

The leading authority is *SEC v. Ralston Purina*.[14] The Supreme Court began by saying that the "design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose."[15] The court then concluded that "the

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[12] *See* Michael Piwowar, Acting SEC Chairman, Remarks at SEC Speaks 2017, Washington, D.C.: Remembering the Forgotten Investor (Feb. 24, 2017) ("Unlike merit-based regimes, our system of disclosure comports well with American traditions of self-reliance, pioneering spirit, and rugged individualism. By arming investors with information, they can evaluate and make investment decisions that support more accurate valuations of securities and a more efficient allocation of capital."); Knight, *supra* note 9, at 4 (the accredited investor category denies individuals the choice to take certain financial risks).
[13] H.R. Rep. No. 73-85, at 5 (1933).
[14] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[15] *Id.* at 124–25 (footnote omitted).

exemption question turns on the knowledge of the offerees," who were employees of Ralston Purina, and that the "focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose."[16]

The court referred to the actual knowledge of the offerees of information that would be in a registration statement and to their access to that information. "Access" did not mean the ability of an outsider to ask or bargain for information and receive it. Rather, it was about "executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement."[17]

The opinion also said that an "offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering,'"[18] but that phrase has been misconstrued and taken out of context over the years. The question was whether a person needed the protections of the Act, and the protections of the Act were the disclosures in a registration statement. People able to fend for themselves were those possessing or having access to the information that would be in a registration statement. Being able to fend for yourself did not mean wealth, sophistication, or the ability to sustain a loss.

More than 20 years later, the Fifth Circuit in *Doran v. Petroleum Management Corp*.[19] considered the private offering exemption and *Ralston Purina*. The *Doran* decision has become a leading authority and is featured in several securities regulation casebooks.[20] The court decided that the private offering exemption did not apply unless "each offeree had been furnished

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[16] *Id.* at 126, 127.
[17] *Id.* at 125–26.
[18] *Id.* at 125.
[19] Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977).
[20] STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION 668 (5th ed. 2019); JOHN C. COFFEE JR. ET AL., SECURITIES REGULATION 353 (13th ed. 2015).

information about the issuer that a registration statement would have disclosed or ... each offeree had effective access to such information."[21]

The Fifth Circuit drew a distinction between offerees who were furnished with the information a registration statement would provide and offerees who had access to that information. All offerees must have the information available in one of the two ways "as a necessary condition of gaining the private offering exemption."[22]

A high degree of business or legal sophistication of all offerees was not sufficient to qualify for the private offering exemption. "Sophistication is not a substitute of access to the information that registration would disclose."[23] There "must be sufficient basis of accurate information upon which the sophisticated investor may exercise his skills."[24]

Sophistication of an offeree matters when an offeree is provided access to information but does not receive actual disclosure of information. The "investment sophistication of the offeree assumes added importance [when offered access], for it is important that he could have been expected to ask the right questions and seek out the relevant information."[25]

The two cases established the principle that the private offering exemption applies when all offerees either have the information that would be in a registration statement or have access to that information. They can then fend for themselves. Investor sophistication is a consideration when an offeree has access but has not actually received the relevant information. As interpreted in these cases, the section 4(a)(2) private offering exemption was about offers to persons with or able to obtain the relevant disclosures and information and was not about special opportunities

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[21] *Doran*, 545 F.2d at 897; *see also* Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir. 1959).
[22] *Doran*, 545 F.2d at 903.
[23] *Id.* at 902.
[24] *Id*. at 903.
[25] *Id.* at 905.

for the wealthy or financially sophisticated. It was not about systematically excluding broad swaths of the population from investment opportunities.

C. SEC Regulations to Implement the Private Offering Exemption

Judicial constructions of the private offering exemption in section 4(a)(2) did not provide the marketplace with the definiteness and certainty it demanded. The SEC addressed this problem with a series of rules leading to Regulation D and the concept of the accredited investor. As that category evolved, it grew further apart from appropriate disclosure and the court interpretations in *Ralston Purina* and *Doran*.[26]

Early SEC efforts to bring more certainty to the private offering exemption followed the *Ralston Purina* principle of disclosure of or access to the information that would have been in a registration statement. That was true for a 1962 interpretation[27] and for Rule 146, which was adopted in 1974. Rule 146 required substantial disclosures to each offeree unless the offeree had access to the information that would be in a registration statement. The SEC broadened the concept of access in *Ralston Purina* to mean an employment or family relationship or economic bargaining power that enabled the offeree to obtain information from the issuer to evaluate the merits and risks of the investment. The Rule also had provisions addressing an offeree's ability to evaluate or bear the economic risks of the investment.[28]

The SEC and Congress moved toward the current definition of accredited investor with developments in 1979 and 1980. The SEC proposed Rule 242 in 1979 and adopted it in 1980.[29]

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[26] A few paragraphs in this section appeared in substantially similar form in Vollmer, *supra* note 8.

[27] SEC, Non-Public Offering Exemption, 27 Fed. Reg. 11,316 (Nov. 16, 1962) (interpretation of private offering exemption, which depended mainly on "full disclosure of information" necessary to an informed investment decision).

[28] 17 C.F.R. § 230.146(d), (e) & note (1979).

[29] *See* SEC, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362 (Jan. 28, 1980) (adoption of final rules).

The Rule had a category of accredited person, which included institutional investors and any person buying $100,000 or more of the offered securities. No disclosure document was needed if sales were made only to accredited persons. The SEC relied "on the ability of such persons to ask for and obtain the information they feel is necessary to their making an informed investment decision."[30] Also in 1980, Congress passed the Small Business Investment Incentive Act, which exempted offers and sales solely to accredited investors and defined accredited investors as one of five types of institutional entities or any person who—on the basis of factors such as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management—qualified as accredited under SEC rules.[31]

The SEC then proposed Regulation D in 1981 and adopted it in 1982.[32] It was a series of rules with exemptions and a safe harbor from the section 5 registration process for certain securities sales by issuers. It defined a category of accredited investors that included institutional investors, any person who purchased $150,000 of the securities so long as the purchase did not exceed 20 percent of the person's net worth, and a natural person meeting either an income or net worth test. The regulation also required that a non-accredited investor be sophisticated or have a sophisticated representative.

Under the current version of Regulation D, accredited investors continue to include legal entities and natural persons. For example, banks, registered broker-dealers, insurance companies, and registered investment companies are accredited investors. Tax-exempt charitable organizations, corporations, and partnerships with more than $5 million in total assets are

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[30] *See* SEC, Exemption of Limiting Offers and Sales by Corporate Issuers, 44 Fed. Reg. 54,258, 54,259 (Sept. 18, 1979) (proposed amendments to rules).
[31] *See* Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).
[32] SEC, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (adoption of final rules).

accredited investors if they were not formed for the purpose of acquiring the offered securities. Individuals with a net worth of over $1 million excluding the value of a primary residence and individuals with an annual income of more than $200,000 or joint income of over $300,000 are accredited investors.[33]

In August 2020, the SEC adopted amendments to the regulatory definitions to create new categories of natural persons and legal entities that qualify as accredited investors. For example, the new definitions cover natural persons with certain professional certifications or credentials from an accredited educational institution, such as broker-dealer employees holding a specified professional license.[34] The new definitions allow certain knowledgeable employees at private investment funds to invest in the funds.[35] The SEC added new legal entities such as registered investment advisers[36] and limited liability companies that have total assets in excess of $5 million and were not formed for the specific purpose of acquiring the securities being offered.[37] The SEC did not know the number of current accredited investors and did not know how many more accredited investors would be added by the new definitions.[38]

The SEC has explained that it has sought to be consistent with the basic criteria in *Ralston Purina* and that the accredited investor definition encompasses those "persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves

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[33] *See* Rule 501(a), 17 C.F.R. § 230.501(a).
[34] Adopting Release, *supra* note 2, at 26–31.
[35] *Id.* at 38–40.
[36] *Id.* at 44–45. .
[37] *Id.* at 49–50.
[38] *See* Proposing Release, *supra* note 3, at 2601 ("We are not able to directly estimate the number of current accredited investors that would be affected by the proposed amendments as precise data on the number of individuals and entities that currently qualify as accredited investors are not available to us."), 2602 ("We are not able to directly estimate the number of individuals who may newly qualify as accredited investors as a result of the proposed" amendments.), 2603 ("while we have information to estimate the number of some categories of institutional accredited investors, we lack comprehensive data that will allow us to estimate the unique number of investors across all categories of institutional accredited investors"); *see also* Adopting Release, *supra* note 2, at 32, 42, 45, 49, 102, 104, 105.

render the protections of the Securities Act's registration process unnecessary."[39] Such persons have "the ability to assess an investment opportunity—which includes the ability to analyze the risks and rewards, the capacity to allocate investments in such a way as to mitigate or avoid risks of unsustainable loss, or the ability to gain access to information about an issuer or about an investment opportunity—or the ability to bear the risk of a loss."[40]

The category of accredited investors plays an important role in the operation of the safe harbor from registration in Rule 506 of Regulation D. One part of the Rule, Rule 506(c), allows an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors using general solicitation or advertising as long as all buyers are accredited investors and the issuer takes reasonable steps to verify that they are. The other part of the Rule, Rule 506(b), allows an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors and up to 35 non-accredited investors as long as the non-accredited investors are sophisticated or have sophisticated representatives and as long as the issuer does not use general solicitation or advertising. The SEC explained that qualifying "as an accredited investor is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds."[41]

One other provision in Regulation D sets accredited investors apart. The regulation states that sales made only to accredited investors do not need any disclosures. Current Rule 502(b)(1) states: "If the issuer sells securities under Rule 506(b) to any purchaser that is not an accredited

[39] Proposing Release, *supra* note 3, at 2577.
[40] Adopting Release, *supra* note 2, at 6.
[41] *Id.* at 5.

investor, the issuer shall furnish the information specified [in another part of the Rule] to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities . . . to any accredited investor." The Rule has a note referring to the "anti-fraud provisions of the federal securities laws" and encouraging issuers to provide information to accredited investors when they provide information to non-accredited investors.

The net effect is striking. Issuers may use Rule 506 to sell an unlimited dollar amount of securities to an unlimited number of accredited investors, and the issuers have no legal obligation to disclose anything.

The private offering exemptions in Rules 506(b) and 506(c) of Regulation D are extremely popular, with the market showing a decided preference for Rule 506(b) transactions that do not include any non-accredited investors. In 2018, the amount raised using Rule 506(b) was $1.5 trillion, and the amount raised using Rule 506(c) was $211 billion. These amounts were mostly for pooled investment funds. The amount raised under Rule 506 exceeded the amount raised in registered public offerings in 2018, which was $1.4 trillion.[42] In 2019, the amount raised under Rule 506 was $1.56 trillion, and the amount raised in public offerings was $1.2 trillion.[43] Only a small percentage of Rule 506(b) transactions have included non-accredited investors. The SEC statement adopting recent amendments to the accredited investor definitions estimated "that, from 2009 to 2019, only between 3.4% and 6.9% of the aggregate number of offerings conducted under Rule 506(b) included non-accredited investor purchasers" for a

[42] *Id.* at 2576–77, 2603–04.

[43] SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956, 17,957–58 (Mar. 31, 2020) ("Exemption Release") (proposing release).

negligible amount of capital in those transactions.[44] One study found that 88 percent of Rule 506 offerings of $1 million or less were limited to accredited investors.[45]

In its August 2020 statement, the SEC noted that it had received public comments recommending the elimination of the accredited investor definition completely, but the SEC's explanation of its actions did not refute or give serious consideration to that option.[46] The next Part of the paper ventures into that discussion.

II. The Advantages and Disadvantages of the Accredited Investor Category

Aside from its long pedigree, does the category of accredited investors continue to be useful? Do strong reasons remain for maintaining a category of accredited investors, or could the category be abandoned with net benefits to capital formation and investor protection? That is the topic of this portion of the paper. It discusses the benefits of retaining the accredited investor category and then describes several reasons for not keeping it. The reasons for dispensing with the line between accredited and non-accredited investors are extremely strong. In particular, as explored in detail, the SEC's rationale for the accredited investor category is deeply flawed, and many of the components of the category fail to effectuate even the flawed rationale.

A. Reasons to Keep the Accredited Investor Category

There are reasons to keep the accredited investor category; it produces some benefit. Issuers selling to accredited investors do not need to incur the costs of providing a list of mandatory disclosures. Regulation D does not require any disclosures to accredited investors.

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[44] Adopting Release, *supra* note 2, at 97.
[45] Rutherford B. Campbell Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 930 table VII (2011).
[46] *See* Adopting Release, *supra* note 2, at 9–10.

It also does not forbid an issuer from making disclosures to accredited investors, and anecdotal evidence revealed that practitioners often made disclosures even when the only buyers were accredited investors.[47] That led me to collect data about the actual disclosure practice in private securities offerings to accredited investors by interviewing lawyers with extensive and recent experience representing participants in those offerings.

My survey of experienced practitioners showed that the deals sold to accredited investors always involved the supply of some information. The minimum was investor due diligence on founders or corporate records, and the maximum was a placement memorandum resembling a prospectus for a registered offer. Various factors, such as the nature of the buyers and the maturity and risks of the company's business, were important considerations in determining the amount of disclosure. Other factors were the size of the offering and the amount of legal and accounting fees the issuer was able to spend on preparation of disclosure. Transactions with a financial intermediary or sales to less sophisticated accredited investors had more extensive disclosures. Sales to venture capital buyers often did not have a specially prepared disclosure document but involved a stock purchase agreement with representations and warranties from the issuer together with a disclosure schedule to modify or qualify the representations and warranties.[48]

As a result, the real benefit of Rule 506 sales solely to accredited investors is that issuers have flexibility about the extent of the disclosures they make. They are able to decide on the disclosures that fit their company and target market of investors. They are free to conform disclosures to meet a series of factors, including the stage of development they are in, the level of sophistication of the buyers, and the amount of resources the company has. The current regulatory

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[47] *See* Concept Release, *supra* note 9, at 30,480 (stating that "issuers and funds conducting private accredited investor-only offerings often provide prospective purchasers with information about the issuer").
[48] *See* Vollmer, *supra* note 8.

structure allows the marketplace to set the right amount of voluntary disclosure. That freedom of choice and freedom from regulatory command is an attractive feature of the current system.

The practice of the legal experts who responded to the survey shows that the system is working in a commendable way. The practitioners deserve credit for making judgments about the types of buyers, companies, and transactions that need little, medium, or major disclosure. The interests of the issuers in getting a good price for the securities and avoiding liability no doubt were motivating factors, but the lawyers in the survey also acted to fill a gap in the law, exceeding minimum legal standards and providing higher levels of investor protection in keeping with general principles of the federal securities laws.

Nonetheless, the voluntary disclosures did not provide all the benefits of a mandatory disclosure system. Mandatory disclosures assure a minimum amount of key information. They are consistent and predictable and allow comparability between similar issuers. They reduce the need for investors to incur duplicative costs to obtain the information covered by the obligatory items.[49] The disclosure decisions described by the survey respondents sounded reasonable, but the disclosures varied widely and were subject to the issuer's discretion and resource constraints.

The evidence from the survey has implications for Rule 506 private offerings because the information from the survey blurs the line between sales to accredited investors and sales to non-accredited investors. Under Rule 506, a major difference is that no disclosures to accredited investors are required while disclosures to non-accredited investors are required. The ubiquity of issuer disclosures in private offerings to accredited investors goes a long way toward erasing the difference between accredited investors and non-accredited investors. The other major

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[49] *See* CHOI & PRITCHARD, *supra* note 20, at 26–30 (discussing the costs and benefits of mandatory disclosure).

distinction is that an issuer may not use a general solicitation or general advertising if a non-accredited investor buys.

B. Reasons to Eliminate the Accredited Investor Category

The reasons to consider eliminating the accredited investor category make up a much longer list and far outweigh the benefits from the current system. The distinction in Rule 506 between accredited investors and non-accredited investors is not good policy, does not serve its intended objectives, and does not provide a net regulatory benefit.[50]

1. Negative consequences from the accredited investor category. The accredited investor rules have adverse effects. They exclude many investors from private offerings. As a legal and practical matter, non-accredited investors do not participate in Rule 506 offerings. Rule 506(c) does not allow any non-accredited buyers. Rule 506(b) limits the number of non-accredited buyers in a transaction to 35, but only 3.4 to 6.9 percent of Rule 506(b) transactions had non-accredited buyers.[51] Given that, in recent years, Rule 506 transactions raised more money than registered offerings or exempt transactions in which non-accredited investors may buy, non-accredited investors do not participate in a large segment of primary offerings to raise capital.

Recently, the objection has been that non-accredited investors have been excluded from attractive investment opportunities in growing private companies.[52] The exclusion has chafed

[50] Some of the following points are from a comment I submitted to the SEC in response to the Concept Release. Vollmer, *supra* note 9, at 5–9.
[51] Adopting Release, *supra* note 2, at 97.
[52] *See id*. at [122] ("investors that do not qualify for accredited investor status may not be able to participate in the high-growth stage of these [private] issuers because it often occurs before they engage in registered offerings"); Concept Release, *supra* note 9, at 30,467.

more as high-growth companies have remained private much longer.[53] The chairman of the SEC objected to the accredited investor concept because it limits the ability of the bulk of retail investors to invest in startups during their high-growth phase. In June 2018 testimony before the House Financial Services Committee, Chairman Clayton said, "Because it is generally difficult and expensive for Main Street investors to invest in private companies, they will not have the opportunity to participate in the growth phase of these companies to the extent they choose not to enter our public markets or do so only later in their life cycle."[54] The Treasury Department raised similar concerns in an October 2017 report: "To the extent that companies decide not to go public due to anticipated regulatory burdens, regulatory policy may be unintentionally exacerbating wealth inequality in the United States by restricting certain investment opportunities to high income and high net worth investors."[55] According to this view, the accredited investor category divides the universe of investors into favored and disfavored classes.

The definitions of accredited investors involve governmental classifications of the investing public, embracing some and excluding others. Part of the discussion below demonstrates that the SEC's definitions necessarily engage in drawing fine lines between different types of investors and inevitably end up with arbitrary and irrational distinctions. Sorting investors into the favored and disfavored classes heightens government intrusion into and control of private decisions and capital allocation. Definitions based on sophistication,

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[53] In the Adopting Release, *supra* note 2, at 122 n.361, the SEC cited research that the median age of a firm that went public was five years in 1999 but was ten years in 2018.
[54] *Oversight of the U.S. Securities and Exchange Commission: Hearing Before the H. Comm. on Financial Services*, 115th Cong. 3 (2018) (statement of Jay Clayton, Chairman, Securities and Exchange Commission); *see also* Piwowar, *supra* note 12 ("[P]rohibiting non-accredited investors from investing in high-risk securities amounts to a blanket prohibition on their earning the very highest expected returns."); Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013).
[55] U.S. Treasury Dep't., 2017-04856 (Rev.1), A Financial System That Creates Economic Opportunities: Capital Markets, at 27 (Oct. 2, 2017).

financial acumen, wealth, or ability to bear a loss are over- and under-inclusive and pry into personal privacy.

This governmental intervention reduces the personal liberty and autonomy of investors. The fundamental reform of the Securities Act, the need for an effective registration statement making a series of mandatory disclosures to sell securities,[56] was to increase the flow of accurate information, not to protect investors in a paternalistic way from potentially bad investments. The Securities Act allowed any person to buy a security in a registered offering. If investors had true information about a company and its securities, they could make up their own minds about whether to buy. The law did not limit potential investors to financial institutions or natural persons with a large net worth or with the ability to sustain the loss of the investment. The evolution of the accredited investor definition is not consistent with legislation aimed at transmitting enough information to allow investors to make their own choices and protect themselves. A comment sent by a private person to the SEC about the exemptions from the registration requirement made the point when it argued for the abolition of the accredited investor category to "increase the freedom and liberty of the American public."[57]

At the time of voting on the new amendments to the accredited investor definition, SEC Commissioner Hester Peirce expressed concerns about denying non-accredited investors the freedom to invest in private companies. "Why shouldn't mom and pop retail investors be allowed to invest in private offerings? Why should I, as a regulator, decide what other Americans

[56] 15 U.S.C. § 77e.
[57] Nathan Eames, Comment on the Concept Release (Sept. 1, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6049842-191371.htm.

do with their money?" They should have both the freedom and responsibility to make investment decisions for themselves. The government should respect the "liberty interests" of all investors.[58]

Another disadvantage of the accredited investor rules is that they increase compliance and enforcement costs. Issuers in Rule 506 transactions either must have a reasonable belief or must take reasonable steps to verify that a buyer is an accredited investor. Issuers therefore must use verification procedures. The obligation to use reasonable verification steps under Rule 506(c) drew complaints about the costs and burdens, leading the SEC to propose some minor relief from the requirement.[59] A further cost is that issuers can make mistakes when using verification methods or identifying accredited investors, which creates the risk of losing the exemption or being embroiled in an enforcement investigation or proceeding.

2. Flaws in the rationale and definition of accredited investors. In addition to these negative consequences, the accredited investor category is badly conceptualized and poorly implemented. First, mandatory disclosure was the main reform of the Securities Act, and the absence of a disclosure requirement in Regulation D for accredited investors is not consistent with that reform. Although the registration requirement was and is subject to exemptions, the regulatory emphasis should lean toward disclosure obligations and against exceptions from disclosure.

Second, the definition of accredited investors does not comport with the type of offeree or buyer needed to qualify for the private offering exemption in section 4(a)(2) under the leading court decisions. The leading judicial interpretation applied the section 4(a)(2) exemption to those able to fend for themselves,[60] but that phrase has been misapplied. People able to fend for

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[58] Hester M. Peirce, Commissioner, SEC, Statement on Amending the "Accredited Investor" Definition (Aug. 26, 2020), https://www.sec.gov/news/public-statement/peirce-accredited-investor-2020-08-26.
[59] Exemption Release, *supra* note 43, at 17,980–81.
[60] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

themselves were those possessing or having access to the information that would be in a registration statement. Sophistication of an offeree played a role when the offeree was provided access to information but did not receive actual disclosure of information. Being able to fend for yourself did not mean wealth or the ability to sustain a loss.

Over time, the definition of an accredited investor expanded and changed and now is not closely correlated with a person who has information or access to it. Under the current definition, a natural person is an accredited investor based on net worth of $1 million excluding primary residence or annual income of $200,000 to $300,000, and legal entities such as corporations, partnerships, and nonprofit institutions are accredited investors if they have total assets over $5 million and were not formed for the specific purpose of acquiring the offered securities. Banks, broker-dealers, and insurance companies are accredited investors. Those criteria and types of entities do not provide a rational connection to an investor's possession of the information that would be in a company's registration statement or to a position or relationship with the issuer that makes the information available to an investor. Involvement in the financial system, wealth, or assets have no bearing on a person's actual knowledge about a particular company. Sophistication and access to information are discussed below. Therefore, for the most part, the accredited investor definition has lost its relationship to the private offering exemption in section 4(a)(2) as construed in *Ralston Purina* and *Doran*.

This became more explicit with the SEC's recent amendments to the accredited investor definition. In its explanation of the amendments, the SEC refused to add knowledgeable employees of a non-fund issuer as accredited investors. The SEC said that idea "could reduce investor protections, to the extent that a knowledgeable employee may have information about a company's business operations, but not possess the relevant financial sophistication to assess the

company's offerings that a more senior officer or director or another type of accredited investor would have."[61] That was a rejection of the Supreme Court's interpretation of section 4(a)(2) in *Ralston Purina* and a victory for the replacement rationale of financial sophistication. One of the new amendments appeared to be based on *Ralston Purina* but ultimately was also a partial rejection of it. Knowledgeable employees of a private fund are now accredited investors for investments in the fund.[62] This type of accredited investor does not rest solely on knowledge about the issuing fund, however. To qualify, some employees must also have financial expertise from participating in the investment activities of the fund for at least a year: "participating in the management of a fund's investments is what gives the employee sufficient knowledge and expertise."[63] The recent SEC actions signal a failure to adhere to the *Ralston Purina* determination that an investor's knowledge about an issuer is the foundation for the private offering exemption.

Third, the SEC's rationale for the accredited investor category is not cohesive and consistent. The SEC gave this rationale: "The characteristics of an investor encompassed within this standard . . . include the ability to assess an investment opportunity—which includes the ability to analyze the risks and rewards, the capacity to allocate investments in such a way as to mitigate or avoid risks of unsustainable loss, or the ability to gain access to information about an

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[61] Adopting Release, *supra* note 2, at 152.
[62] *Id.* at 38-40.
[63] *Id.* at 40. One of the original types of accredited investors was closely aligned with *Ralston Purina*. Directors and executive officers of an issuer are accredited investors. *See* Rule 501(a)(4), 17 C.F.R. § 230.501(a)(4); SEC, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,262–63 (March 16, 1982). Their positions give them knowledge of or access to information necessary to an informed investment decision. *See* SEC, Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, 46 Fed. Reg. 41,791, 41,796 (Aug. 18, 1981) (including executive officers and directors of an issuer as accredited investors based on then existing Rule 242(a)(1)(iii)); SEC, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6,362, 6,364 (Jan. 28, 1980) (including directors and officers as accredited persons in Rule 242, which reflected "the Commission's determination that, by virtue of his position with the issuer, an executive officer or director will have access to information which is necessary for him to make an informed investment decision about the issuer's securities"); *see also* Adopting Release, *supra* note 2, at 38–39, 151.

issuer or about an investment opportunity—or the ability to bear the risk of a loss."[64] In essence, the SEC's reasons to set accredited investors apart are sophistication and experience with financial investments or the capacity to lose money, but the reasons are flawed.

Ability to bear a loss is an odd factor and does not deserve much weight. It is not connected with knowledge of the information that would be in a registration statement, financial sophistication, understanding of the risks and rewards of an investment, or the experience or knowledge to ask the issuer the right questions. The SEC conceded that an investment loss of an investor who is sophisticated but who lacks a high net worth or income could be significant.[65] Even wealth and income are not closely aligned with the ability to lose money. People tend to have low wealth at younger ages, build wealth during peak working and earning years, and then spend their saved money during retirement.[66] As a result, people are likely to have more wealth toward the time they can least afford to lose it. In addition, the wealth and income tests are not tied to the amount of a person's investments. No matter how wealthy a person is, he or she is unlikely to be able to bear a loss that exceeds the person's net worth or annual income. An individual with a net worth of $4.5 million would face hardship from an investment loss of $5 million.[67]

The dominant theme in the SEC's accredited investor approach is a person's ability to assess and analyze the risks and rewards of an investment opportunity and avoid bad choices, but this emphasis on financial sophistication is not consistent with the absence of a mandatory

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[64] Adopting Release, *supra* note 2, at 6.
[65] Proposing Release, *supra* note 3,at 2583.
[66] Scott A. Wolla & Jessica Sullivan, *Education, Income, and Wealth*, Page One Economics, Federal Reserve Bank of St. Louis (Jan. 2017), https://research.stlouisfed.org/publications/page1-econ/2017/01/03/education-income-and-wealth/; Federal Reserve Bank of St. Louis, *The Effect of Aging on Wealth Inequality*, ON THE ECONOMY BLOG (Mar. 13, 2017), https://www.stlouisfed.org/on-the-economy/2017/march/effect-aging-wealth-inequality ("People generally accumulate wealth as they age, and then begin spending down their assets once hitting retirement.").
[67] *See* Knight, *supra* note 9, at 13.

disclosure requirement for sales to accredited investors. No matter how sophisticated, an investor is not capable of evaluating an investment opportunity with little or no information about the investment. There "must be sufficient basis of accurate information upon which the sophisticated investor may exercise his skills."[68]

This means that the SEC's reason for giving special treatment to sophisticated investors places great—but inadequately justified—weight on their presumed ability to request and obtain the necessary information. The SEC included "the ability to gain access to information about an issuer or about an investment opportunity" as one characteristic of financial sophistication. The *Doran* decision connected sophistication with the ability to request the right kind and amount of information: The "investment sophistication of the offeree assumes added importance [when offered access], for it is important that he could have been expected to ask the right questions and seek out the relevant information."[69] The SEC also relied on that assumption about sophisticated investors in proposing a private offering rule adopted in 1980.[70]

Despite the obvious importance of a person's ability to request relevant information given the lack of required disclosures, the SEC devoted almost no attention to this factor in its four recent lengthy reviews of the accredited investor category.[71] The SEC did not produce evidence that each of the different types of accredited investors in fact knows what information to demand from securities issuers. It did not produce evidence that accredited investors actually request information and obtain it. The SEC did not discuss data on whether issuers refuse requests in certain situations or from certain types of accredited investors, such as natural persons. The SEC

[68] Doran v. Petroleum Management Corp., 545 F.2d 893, 903 (5th Cir. 1977).
[69] *Id.* at 905.
[70] *See* SEC, Exemption of Limiting Offers and Sales by Corporate Issuers, 44 Fed. Reg. 54,258, 54,259 (Sept. 18, 1979) (proposing a category of accredited persons and referring to their ability "to ask for and obtain the information they feel is necessary to their making an informed investment decision").
[71] *See* Adopting Release, *supra* note 2; Accredited Investor Proposing Release, *supra* note 3; Concept Release, *supra* note 9, at 30,470–79; SEC Staff, Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015).

did not discuss the utility or effectiveness of Rule 502(b)(v), which requires an issuer in a Rule 506(b) transaction to make available an opportunity to ask questions and receive answers. It did not discuss or explain why that opportunity exists in Rule 506(b) transactions but not in Rule 506(c) transactions, in which all buyers must be accredited investors. The SEC did not test or sustain the theory that financial sophistication results in appropriate disclosure.

The results of my survey of practitioners experienced in private offerings to accredited investors fill this gap to some extent. Survey respondents said that issuers typically provided prospective buyers with an opportunity to ask questions and receive answers and additional information and that potential buyers have taken up this offer and have sometimes recommended or suggested items for disclosure. In addition, the main result of the survey was that issuers provided some form of information or disclosures in nearly every private offering to accredited investors.[72]

On the surface, the practice of making voluntary disclosures to accredited investors appears to support the idea that sophisticated investors seek out and obtain information relevant to an investment, but the interviews during the survey conveyed that the issuers rather than the investors initiated the disclosures and the issuers adjusted the extent of the disclosures to different audiences. My sense from the interviews was that issuers and their lawyers prompted the disclosures and made them of their own volition at least in part to provide essential information to potential buyers. Several survey respondents said that Form S-1 and Regulation S-K were guides for the disclosures, suggesting that the mandatory disclosure regime of the federal securities laws acted as a major influence on the level of voluntary disclosures. Years of experience with registered offerings and reporting companies set standards for appropriate

[72] *See* Vollmer, *supra* note 8.

disclosure. One respondent said that when "the resources are available, the preference is to provide substantially the same level of disclosure that would be provided if the offering also would be placed with non-accredited investors. SEC-mandated line-item disclosures provide a roadmap to material disclosures required to satisfy the anti-fraud provisions of the federal securities laws." Another survey respondent differed and attributed the influence of standard securities law disclosures to the expectations of investors, who have become accustomed to those disclosures. Causes and effects are difficult to separate—issuers and their advisers could be making disclosures at their initiative because of experience with and expectations about investor demand—but lawyers in the survey more frequently cited the preferences of issuers for the voluntary disclosures. For these reasons, there is not strong support for the view that the types of persons classified as accredited investors have and exercise the ability to seek out and obtain information relevant to an investment.

The fourth problem with the SEC's conception of accredited investors is that several of the types of persons in the current and proposed definition do not meet the financial sophistication criteria of the SEC's standard. That is not to say that all types fail the test; many easily qualify as financially sophisticated, such as banks, broker-dealers, and insurance companies. The leading example of a type of accredited investor that fails to comport with the SEC's standards is a natural person who meets the net worth or income test. Those tests have been criticized for a wide variety of reasons.[73] Net worth or income does not provide a rational connection to an investor's ability to fend for him- or herself by having knowledge of

[73] *See* Proposing Release, *supra* note 3, at 2593; Concept Release, *supra* note 9, at 30,473–77; SEC Staff, Report on the Review of the Definition of "Accredited Investor" 44 (Dec. 18, 2015); Knight, *supra* note 9, at 13–14 (describing criticisms of the accredited investor definition); Zimmerman, *supra* note 9 (describing criticisms of the type of individuals included as accredited investors and citing authorities); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U.L. REV. 733, 736 n.23, 747 nn.110–11 (2009) (describing criticisms of the type of individuals included as accredited investors and citing authorities).

information in a registration statement or having an ability to ask for and obtain the information felt necessary to making an informed investment decision. Income and wealth are not effective ways of identifying the persons who understand the risks of buying securities. An individual may acquire high compensation or wealth in many ways other than actions that provide a basis for evaluating an investment opportunity. The financial tests include individuals who have no ability to evaluate securities investments and exclude individuals who do have the ability.[74]

The SEC's current position on the wealth tests for natural persons is not comprehensible. For a long time, the SEC defended and used the wealth tests as acceptable substitutes for financial sophistication: "in the case of individuals, the accredited investor definition has used wealth—in the form of a certain level of income or net worth—as a proxy for financial sophistication."[75] In its recent amendments to the definition of accredited investors, the SEC refused to make any changes to the income or net worth tests,[76] but it dismantled the justification for them. Toward the end of a long release, the SEC candidly recognized that "higher income or net worth does not necessarily correlate to a higher level of financial sophistication" in the case of individuals.[77] Thus the effects of inflation on the financial thresholds since 1982 did not

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[74] *See* SEC Staff, Report on the Review of the Definition of "Accredited Investor" 89 (Dec. 18, 2015).
[75] Adopting Release, *supra* note 2, at 6; see also Proposing Release, *supra* note 3, at 2593 ("the current wealth-based criteria are useful for the identification of investors who do not require the protections afforded by registration"). The evidence to support the claim that wealth is related to sophistication is flimsy. The SEC has relied on empirical studies discussed in a 2015 staff report. See Proposing Release, *supra* note 3, 2593 n.205 (discussing SEC Staff, Report on the Review of the Definition of "Accredited Investor" 45 (Dec. 18, 2015)). The studies produced some data to show that wealthier investors engaged in questionable investment behavior less frequently than lower-income subjects, such as delayed sales of losing investments and limited diversification of portfolios, but the results were only that the wealthier did better than the less wealthy and did not establish that wealthier individuals were capable of analyzing the risks and rewards of investment opportunities. For example, one survey the staff discussed "found that higher income individuals correctly answered 3.5 out of five questions on a financial literacy quiz compared to only 2.2 correct responses for lower income individuals." SEC Staff, Report on the Review of the Definition of "Accredited Investor" 45 (Dec. 18, 2015). The staff report was obliged to concede that the studies did no more than "lend support to the theory that wealth is correlated to financial sophistication" and admitted that the "reasons underlying the correlation between wealth and sophistication found in the studies and surveys are not definitively known." *Id*. at 44–46; *see also* Knight, *supra* note 9, at 14 & n.50 ("evidence is mixed").
[76] Adopting Release, *supra* note 2, at 71–76, 143–47.
[77] *Id*. at [146].

correlate to a lower level of financial sophistication,[78] even though the number of US households that qualified as accredited investors had grown from approximately 2 percent of the population in 1983 to 13 percent in 2019.[79] In addition to those statements in the recent release, a majority of the SEC commissioners criticized the wealth tests when the commission voted on the recent amendments to the accredited investor definition.[80] In the end, the best the SEC had to say for the wealth tests was that they should not "be the sole means of establishing financial sophistication of an individual for purposes of the accredited investor definition."[81]

The disconnection between the SEC's financial sophistication standard and types of accredited investors is not limited to the wealth tests for individuals. At least one of the new additions to the accredited investor category is also detached from financial expertise, and it highlights the irrationality of including some legal entities previously defined to be accredited investors. According to Rule 501(a)(3) before the recent amendments, accredited investors include corporations, partnerships, and nonprofit organizations that were not formed to make the specific investment and that have over $5 million in assets. The SEC added limited liability companies to this provision.[82]

The rules for forming an LLC provide no assurance of financial sophistication. A single individual with a very small net worth or income may create an LLC to conduct a personal

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[78] *Id*. at [74].
[79] *Id*. at [144].
[80] See Jay Clayton, Chairman, SEC, Statement on the Modernization of the Accredited Investor Definition (Aug. 26, 2020) ("The Commission's use of income or wealth as the exclusive proxy for an individual's financial sophistication and ability to assess and bear risk has long been unsatisfactory."), https://www.sec.gov/news/public-statement/clayton-accredited-investor-2020-08-26; Hester M. Peirce, Commissioner, SEC, Statement on Amending the "Accredited Investor" Definition (Aug. 26, 2020) ("Today's changes are rooted in a recognition that wealth and income are not always great proxies for an investor's sophistication."), https://www.sec.gov/news/public-statement/peirce-accredited-investor-2020-08-26; Elad L. Roisman, Commissioner, SEC, Commissioner Roisman Statement on Amending the "Accredited Investor" Definition (Aug. 26, 2020) ("wealth is a crude measure of a person's ability to make financial decisions"), https://www.sec.gov/news/public-statement/roisman-statement-amendments-accredited-investor-definition.
[81] Adopting Release, *supra* note 2, at 6.
[82] Adopting Release, *supra* note 2, at 49.

business. The only qualification is that the person needs to be 18 years old. The formation process is cheap, simple, and easy. With minor variations, the same is true for corporations and partnerships.[83] The owners and managers of an LLC, corporation, or partnership do not need to demonstrate any knowledge, education, experience, or ability to evaluate investments or even to conduct the business of the company. The only connection of LLCs, corporations, and partnerships with the ability to evaluate the risks and benefits of a possible purchase of securities is that they are forms of business entities, but the purposes of the different forms of business organization (consolidation of skills and financial resources and management of liability and taxation) are entirely distinct from identifying the ability to evaluate the risks and rewards of a securities investment. The correlation of the business forms to investment ability and acumen is tenuous.

The need to own assets worth more than $5 million does not save the category. Acquiring $5 million in assets is not a sufficient marker of the capability of sophisticated financial analysis.[84]

The provision defining corporations, partnerships, and nonprofit organizations as accredited investors is overbroad. Adding LLCs would be consistent with treating corporations and partnerships as accredited investors but equally irrational. Little supports the SEC's assertion that LLCs "should be considered to have the requisite financial sophistication to qualify as accredited investors."[85] Qualification should depend on characteristics that more reliably connect a particular business with investment capacity.

[83] A website of the state of Delaware has useful information about steps to form a new business entity. *See* Delaware Division of Corporations, *How to Form a New Business Entity*, https://corp.delaware.gov/howtoform/ (last visited Aug. 14, 2020). *See also* WILLIAM K. SJOSTROM JR., BUSINESS ORGANIZATIONS (2d ed. 2016).
[84] *See* Adopting Release, *supra* note 2, at 55–56 (observing that an entity might "have $5 million in non-financial assets such as land, buildings, and vehicles, but not have any investment experience").
[85] *Id.* at 49.

Other new categories of accredited investors do a much better job of corresponding to a person capable of meaningful investment analysis. These include registered investment advisers and natural persons with certain certifications as a securities professional. Nonetheless, expanding the types of persons who qualify as accredited investors continues to require the government to engage in problematic line-drawing. The SEC acknowledged that. Including individuals with some professional credentials excludes individuals with many comparable credentials.[86] Including LLCs and corporations with $5 million of assets but requiring other entities to own investments in excess of $5 million might draw an unnecessary distinction.[87] As discussed above, the objection to this line-drawing is that it involves the government in making indefensible distinctions that favor some and work to the detriment of the personal liberty of the disfavored group.

The list of reasons to discontinue the category of accredited investors for private offerings is long. The category imposes several social costs on the regulatory system, such as the segmentation of the investing public, the infringement on personal liberty, and the added compliance costs, and is in many ways divorced from its objectives. The costs and complications of keeping the accredited investor category seem to be far greater than the benefits. If types of accredited investors do not possess proper information about a company, do not know enough to demand the right kinds of information, and lack the education or experience to analyze the financial implications of a purchase of a security, then they are not different from non-accredited investors in a way that is relevant to satisfying the section 4(a)(2) private

[86] *Id.* at 33 ("there may be other professional certifications, designations, and credentials that indicate a similar level of sophistication in the areas of securities and investing").

[87] Hester M. Peirce, Commissioner, SEC, Statement on Amending the "Accredited Investor" Definition (Aug. 26, 2020) (saying that she did "not see a valid reason for applying an asset test to certain entities, while applying an investment test to Indian tribes and other governmental bodies"), https://www.sec.gov/news/public-statement/peirce-accredited-investor-2020-08-26.

offering exemption. If they are not different in a legally relevant way from non-accredited investors, the distinction should be eliminated. Getting rid of the accredited investor classification would generate various economic benefits[88] and would pave the way to a better regulatory safe harbor for private offerings.[89]

III. Possible Approaches to the Elimination of the Accredited Investor Category

What would be a better approach to a private offering safe harbor if the accredited investor category were abolished? The leading judicial decisions on section 4(a)(2) and the results of my survey of private offering practitioners prompt some possibilities.

One would be a private offering exemption that removes the difference between accredited and non-accredited investors, continues not to require any disclosures, and continues to rely on issuers to provide sufficient voluntary disclosures. Offerings would be open to all investors.

Under this exemption, issuers would likely continue to make voluntary disclosures, but the potential buyers would be all types of investors and not just those with a patina of sophistication. As today, the disclosures would not necessarily produce all the benefits that mandatory disclosures generate: supply of a minimum amount of essential information, consistency, predictability, and comparability. The flexibility and discretion of a voluntary disclosure system could but probably would not meet the requirements of the section 4(a)(2)

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[88] The SEC's statement adopting expanded definitions of accredited investors described the economic costs and benefits for investors and issuers of a larger investor base for Rule 506 transactions. *See* Adopting Release, *supra* note 2, at 98–100, 111–37. Removing the accredited investor category entirely would have several of the same effects.

[89] Another writer proposed that the SEC retain the accredited investor category but allow both accredited and non-accredited investors to buy in a private offering if they have retained a purchaser representative who is a registered broker-dealer or an investment adviser required to act in the investor's best interest. *See* Thomas M. Selman, *Protecting Retail Investors: A New Exemption for Private Securities Offerings*, 14 VA. L. & BUS. REV. 41, 44–45, 62–63 (2020).

private offering exemption: knowledge or actual receipt of or ready access to the essential information that would be in a thorough company disclosure.

The real problem with an exemption of this sort, however, is that it would go down a path toward repeal of the registered offering in the Securities Act. In the Securities Act, Congress replaced a system of voluntary disclosures from issuers with the registered offer requiring a list of mandatory disclosures to offerees of all types. An exemption open to all investors and reliant on issuer decisions about disclosures would undo much of that reform, which has become an entrenched and valued part of federal securities regulation. Circumventing it with an exemption would not be acceptable as a legal or policy matter.

Another possible approach to a private offering safe harbor is to eliminate the category of accredited investors but require delivery of a solid disclosure document. If the accredited investor concept is abandoned, a rule-based private offering exemption should return to the central idea for the private offering exemption in section 4(a)(2) of the Securities Act as construed in *Ralston Purina* and *Doran*. The central idea is knowledge or actual receipt of the information that would be in a robust disclosure document or access to that information. The exemption proposed here would rely on the delivery of essential disclosures and would not rely on a person's access to the information or a person's sophistication and ability to request the necessary information. This would avoid possible disagreements over the meaning of "access" to the appropriate disclosures by requiring delivery of them.

The disclosure obligation of the new exemption should provide essential company and security information to buyers but avoid the high costs associated with more extensive disclosures, such as those in a registered offer, a Regulation A offer, or a sale under Rule 506(b)

to a non-accredited investor.[90] The burdensome disclosure obligation for a Rule 506(b) sale to a non-accredited investor is the reason not to eliminate the accredited investor category and extend the current disclosure obligation in Rule 506 to all investors. The test for appropriate disclosure should be the basic information that any investor would require before investing but not the excessive detail and coverage that a registration statement has come to include over time. The new exemption would streamline disclosure of core company information to a prospective buyer, and that disclosure would both satisfy the private offering exemption and dispense with the need for an accredited investor limitation.

A reporting company would need to provide a potential buyer with its main recent public filings and material recent developments. The model for disclosure by a non-reporting company would be the initial offering statement required by Regulation CF, which governs crowdfunding transactions.[91] With some deletions and modifications, the crowdfunding disclosures are a reasonable model for a new private offering exemption because crowdfunding is open to all investors and is aimed at very small startup companies, which are not able to afford the preparation of more extensive disclosures. The mandatory disclosures cover only basic information such as the background of officers and directors, the business of the issuer, the material risk factors, a description of the intended use of proceeds, and the terms of the securities being offered.[92] Some of the obligatory disclosures for a crowdfunding offer are irrelevant or too burdensome, such as disclosures related to the target amount of the offering and the need for

[90] For a discussion of the costs of a registered offering and certain exempt offerings, *see* Vollmer, *supra* note 9, at 10–11. A registration statement must comply with section 5, 15 U.S.C. § 77e, and associated statutes and regulations. A Regulation A transaction must comply with 17 C.F.R. §§ 230.251 to 263.
[91] 15 U.S.C. § 77d-1; 17 C.F.R. §§ 227.100 to 503.
[92] *See* 15 U.S.C. § 77d-1(b)(1); 17 C.F.R. § 227.201.

audited financial statements from companies not able to afford them, and the new exemption should delete them or scale them back.

The only part of Regulation CF that the new exemption would adopt would be the offering statement on Form C,[93] with the modifications and exclusions just described. The other features of the crowdfunding exemption, such as the rules for intermediaries and investors and the remaining rules for issuers, would not be incorporated.[94]

In 2019, the SEC staff used several sources of information to estimate the costs incurred by issuers in conducting equity crowdfunding campaigns during the first two and a half years of the operation of Regulation CF. The costs included an internet site, issuer disclosures, film, video, marketing firm, lawyer, and accountant but excluded the cost of the intermediary broker-dealer or portal. The average cost of disclosures was $6,218. If all of the legal and accounting costs were attributed to the initial disclosures and added to the cost of disclosures, the average

[93] *See* 17 C.F.R. § 227.203(a)(1).

[94] For a detailed description of the rules for the crowdfunding exemption, see the SEC's statement adopting Regulation CF. SEC, Crowdfunding, 80 Fed. Reg. 71,388 (Nov. 16, 2015); *see also* SEC Staff, Regulation Crowdfunding 6–10 (June 18, 2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf. Commentators criticized the costs and regulatory burdens associated with the crowdfunding exemption. *See* Usha R. Rodrigues, *Financial Contracting with the Crowd*, 69 EMORY L.J. 397, 411–18, 440 (2019) (discussing difficulty and expense of using Regulation CF and saying "equity crowdfunding under the SEC's rules and regulations is an arduous process," has "daunting complexity," and is unworkable and broken); Patricia H. Lee, *Access to Capital or Just More Blues? Issuer Decision-Making Post SEC Crowdfunding Regulation*, 18 TRANSACTIONS: TENN. J. BUS. L. 19 (2016); Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. ONLINE 217, 251–55 (2015); Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493 (2014); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433 (2012); Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879 (2011). The basis for the concern that the costs of using the crowdfunding exemption would exceed the benefits was mostly the combination of the many layers of regulatory requirements and not the costs of preparing the initial offering statement. *See* Lee, *supra*, at 19, 38. One writer noted that the crowdfunding disclosure requirements are much less extensive than those for a registered offering. He cited some critics of crowdfunding who said there would be too little disclosure, opening the floodgates to securities fraud (which does not seem to have happened), and he cited other critics who complained there would be too much required disclosure, making crowdfunding too expensive for small issuers to use. Dorff, *supra*, at 506, 508. The reviews of the crowdfunding exemption were not all negative. *See* Qing Burke, "Determinants of Securities Crowdfunding Success under SEC Regulation Crowdfunding" (Miami University of Ohio, Working Paper, Sept. 20, 2019), https://ssrn.com/abstract=3425853 (finding that 63 percent of companies conducting securities crowdfunding campaigns from 2016 to 2018 successfully raised capital and that ventures that have higher revenue and larger management teams, are older in firm age, and are located in California or New York are more likely to receive funds from crowdfunding investors).

cost of the disclosures was $12,804.[95] These data give some idea of the likely modest cost of preparing a disclosure document of the type proposed for the new exemption.

The required disclosures would be a minimum. Issuers would know what disclosures needed to be made but would be free to supplement required disclosures with additional information. Investors and issuers would retain the ability to negotiate other aspects of the sale process, such as the terms of the securities, additional disclosures, or access to books and records for due diligence.

Issuers would be free to sell to any buyer, including a person who is a non-accredited investor under current law. Some issuers might prefer to sell a private tranche only to buyers they know or buyers that meet the current standards for accredited investors. They could do that. The goal of the new approach is to increase the capital base and the flexibility of an issuer.

Requiring an initial disclosure document would impose a compliance cost that current Rule 506 does not impose. Three factors justify the cost. First, the results of the survey of lawyers experienced with private offerings to accredited investors show that the actual practice of most issuers is to incur the cost and burden of preparing a set of disclosures.[96] Making a reasonable set of disclosures mandatory would not significantly increase the costs. Second, disclosure is the essence of the approach of the federal securities laws, and Rule 506 has strayed too far from that concept. Third, the proposed disclosures would be significantly reduced from the disclosures required in other parts of the federal securities laws. The idea for the new exemption is to require core company and security information, but not anything like the disclosures mandated by

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[95] SEC Staff, Regulation Crowdfunding 14, 23, 25 (June 18, 2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf. The total cost of a crowdfunding campaign, again excluding the cost of the intermediary, was approximately 5.3 percent of the amount raised, and the average total cost was $22,479. *Id.* The average cash compensation paid to intermediaries in these crowdfunding offerings was 5.7 percent of the offering proceeds. *Id.* at 47. The SEC staff found little evidence of fraud or misconduct in equity crowdfunding transactions. *Id.* at 42–44.

[96] *See* Vollmer, *supra* note 8.

registered offers or most other exempt offerings. The cost of preparing the envisioned disclosure document is meant to be manageable for startup and small companies and is not meant to be so sizable that use of the new exemption would be prohibitively expensive.

Courts, regulators, and litigants would need to be vigilant to prevent the required disclosures from increasing and growing burdensome over time. The history of many of the mandatory disclosures in the securities laws is that they expand. Specifying them in a regulation should slow that process. In addition, the objective of keeping the costs of using the exemption down and the desire to maintain separation from a registered offer should temper efforts to make the list of obligatory disclosures longer.

The proposed exemption has many more details but, in general, would have very few restrictions and limitations.[97] The intent would be to offer a simple, streamlined, and flexible method of raising capital to a broad range of issuers and all potential investors based on delivery of a reasonable but not unduly costly set of disclosures.

The contemplated private offering safe harbor would be different from a registered offer to the public. The main difference would be the substantially reduced disclosure obligation, and the reason for that difference is the high cost of preparing a registration statement. Other differences could be considered to maintain separation from public offerings. If the SEC believes the new exemption would tread too much into the territory of registered offerings, it could consider a prohibition on the use of general solicitations or a limit on the amount of money that could be raised with the exemption. It could treat securities sold under the exemption as restricted securities for resale purposes. Adding any of these restrictions would

[97] The comment submitted to the SEC described the details. *See* Vollmer, *supra* note 9, at 11–15.

not be desirable, but some might want a greater distinction between exempt private offerings and registered offerings.

IV. Conclusion

The private offering safe harbor in Rule 506 of Regulation D created a type of buyer called accredited investors and simplified sales to them. One simplification was to omit mandatory disclosures to accredited investors.

On examination, keeping the accredited investor category seems to entail costs and complications that exceed the benefits. The theory for the accredited investor category was that it would implement the statutory private offering exemption in a regulatory safe harbor, but, over time, the definition of an accredited investor expanded and changed and is no longer closely correlated with the original concept. Many types of accredited investors do not possess the information about a company and securities offering that would be in a solid set of disclosures and do not have the positions or capacity to have ready access to that information. Under the current approach, the criteria for accredited investors are financial sophistication, moderate financial resources, or the capacity to lose money, yet several of the types of persons in the definitions do not meet the financial sophistication or other criteria of the SEC's standard. That is true for natural persons who are accredited investors because they meet a modest net worth or income test and for many corporations, partnerships, and LLCs.

Recent amendments to the accredited investor definitions created further anomalies. The amendments left in place the heavily criticized net worth and income tests to qualify natural persons, but the rhetoric of the SEC disparaged the wealth qualification. Knowledge about an issuer was originally the predicate for the statutory private offering exemption, but the SEC's recent pronouncement refused to accept knowledge, elevating financial sophistication instead.

Maintaining the category of accredited investors also imposes serious costs. Non-accredited investors have been excluded from attractive investment opportunities in growing private companies. The distinction between accredited investors and non-accredited investors therefore sorts sources of capital into favored and disfavored classes and reduces the personal liberty and autonomy of non-accredited investors. Obeying the rules on accredited investors also increases compliance and enforcement costs.

The SEC should consider developing a private offering safe harbor that removes the distinction between accredited and non-accredited investors and is open to all investors. If it did so, the exemption should require a disclosure document delivered to all offerees, but the set of mandatory disclosures should be much more streamlined and shorter than the disclosures in a registration statement or a public company's annual report. The use of an obligatory disclosure document would return the regulatory private offering exemption much closer to the original understanding in the courts of the statutory private offering exemption. The cost and burden of preparing disclosures should not pose a significant regulatory disincentive to private offerings because evidence from a survey of experienced practitioners showed that issuers currently incur the costs of preparing disclosures in a high percentage of transactions even though the law does not require any disclosures.

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SECURITIES OFFERINGS

Investor-Friendly Securities Reform to Increase Economic Growth

BY ANDREW N. VOLLMER

For years the federal securities laws have burdened the process of raising funds with intricate sets of rules that do little to advance the cause of investor protection. The time is now right for a critical reassessment in three areas:

- the steps companies must follow to sell securities to the public,
- exemptions from the public offering process, and
- the prescribed disclosures for companies selling new securities and periodically reporting on their business.

In each area, the rules have multiplied over time, become encrusted and labyrinthine, and added sizable expense.

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Genuine reform in these areas would reduce the cost of raising capital, feed economic growth and enable job creation, and preserve investor protections. In recent years, according to SEC studies, the total amount of capital raised annually in securities sales regulated by the SEC was approximately $3 trillion. If the cost of raising that capital could be reduced by just one percent, the economy would have $30 billion more each year to devote to new drugs, renewable energy research, new production plants, and more jobs.

The first area to re-think is the cumbersome and costly method for registering securities with the SEC for a public offering. The registration process often takes about six months for emerging companies. A 2012 study by an accounting firm found that total costs for an initial public offering were approximately 8 percent of gross offering proceeds, with smaller offerings incurring a higher percent of costs. [PricewaterhouseCoopers, Considering an IPO? The costs of going and being public may surprise you 7 (2012), available at https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf.] Paying $8 million to raise $92 million in cash is not the best of deals.

Legal requirements are a large part of the problem. The need to prepare a set of complete and accurate disclosures for investors is settled, but other restrictions create a maze with traps. Eminent writers in the field called the statute a ''scheme of involuted drafting'' that ''does not facilitate comprehensibility.'' [Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 93 (4th ed. 2004).]

For example, while a company is working on its formal disclosure documents, the law gags it. Senior executives may not make public comments that could be seen to arouse the interest of potential buyers in the securities to be sold. After filing a draft of the formal disclosure documents with the SEC, a company is freer to communicate with potential investors, but the rules are byzantine. Some written communications are permitted; some are not; some must have warnings or be accompanied by the SEC filing; some do not; some must be filed with the SEC; some do not. The legal restrictions are so convoluted that even well-intentioned and

well-advised companies such as Google and Groupon tripped over them.

A company may avoid the public registration process by taking advantage of exemptions for private or smaller sized offerings. In concept, the exemptions were a welcome relief valve from the more formal registration system, but they too have become gummed up over time with restrictive interpretations or complicated regulatory obligations that have increased costs.

An example is the creative idea of crowdfunding start-up businesses with small amounts from many investors. The idea grew to pages and pages of statutes and regulations that, among other things, require a broker or ''funding portal'' intermediary and oblige the intermediary to ''ensure that each investor'' reviews investor education material and answers questions demonstrating an understanding of investment risk. [See sections 4(a)(6) and 4A of the Securities Act; 17 C.F.R. pt. 227]

The third area needing attention is the list of mandatory disclosures for companies that issue securities or make regular formal reports to investors. The core rules, called Regulation S-K, now take 214 pages in the Code of Federal Regulations, and the print is small. The rules for financial statements, called Regulation S-X, are another 100 pages. [17 C.F.R. pts. 229, 210.]

The extent of the required disclosures has made corporate reports prolix, impenetrable, and expensive. Important information is buried with trivia, making disclosures less useful for both institutional and individual investors. In addition, the 2012 accounting firm survey found that expenses of being a publicly reporting company easily run into millions of dollars every year. One company in the survey estimated that the incremental recurring annual costs related to being a public company are approximately $38 million.

On occasion, Congress has acted to address some of these problems, but a fresh and more thoroughgoing effort is needed. A place to begin is the process for offering securities to the public. The main priority of Congress should be to reduce the cost of preparing the disclosure document and eliminate constricting conditions so that the public registration process is as or more efficient than using an exempt offering under the current system. The main elements of the reform would be to free issuers to communicate about the offering at any time, shorten SEC staff review of a draft registration statement, and promote disclosure to potential buyers before an investment decision is made. Details of a new approach to registered offerings are in the Appendix.

A second feature of reform should be to tailor the information disclosure obligations of issuing and reporting companies to the size of the company. Size could be determined by the value of outstanding securities or total revenue or assets. Newly formed or small companies should need to make only basic disclosures about the company and the securities. Several parts of the existing securities laws already have models for such short-form documents, such as section 4(d)(3) or section 4A(b)(1)(A)-(H) of the Securities Act. Large and established companies should make the full range of disclosures, although that full range must be cut back. Medium-sized companies would have disclosure obligations in between the other two categories. The new categories would replace the different disclosure systems under current law (Forms S-1, S-3, 10-K, 10-Q, Regulation D, Rule 144, Rule 144A, Form 1-A for Regulation A, section 4A(b)(1) (crowdfunding), and Rule 15c2-11).

If the public offering process and the extent of mandatory disclosures were significantly streamlined, the need for exemptions would disappear. The existing complicated and confusing set of exemptions could be swept away with issuing companies using the registration system for all securities sales. A new statute could repeal section 4(a) through (d) and section 4A of the Securities Act, the parts of the JOBS Act on emerging growth companies, Regulation D, and crowdfunding and invalidate the current SEC rules with issuer exemptions, including Regulation D, Regulation A, and crowdfunding.

The exemptions usually restrict resales. For example, the securities in a Rule 506 transaction are restricted securities whose resale is subject to the confusing provisions of Rule 144. The approach here would dispense with the resale restrictions. A company that had sold securities would need to continue to provide sufficient current information to the market to permit reasonable investment decisions and secondary trading, and the securities would be freely tradable by one buyer to another.

The securities laws should have one exemption from the public registration process for issuers, and it should be for very small start-up companies. An issuer should be able to sell securities for total proceeds of up to a small amount (such as $250,000 or $500,000) to a small number of offerees and buyers (such as no more than ten offerees and no more than five buyers including the founders) with no need to comply with any obligation under federal or state securities laws. The exemption should explicitly pre-empt state law. Investors would be protected because the founder would be able to provide information about the business to the small number of possible buyers and because the possible buyers would be in discussions with the founder and could request any further information they wanted. Such an exemption would benefit a large number of entrepreneurs.

A simplified public offering process with reduced disclosure obligations needs a strong private liability system. For registered public offerings, sections 11 and 12 of the Securities Act are a starting point. Issuers should have strict liability for a failure to comply with the public offering rules, for any material statement that is false or misleading, or for any failure to make a required material statement. Others responsible for a misstatement should have a defense of due diligence and reasonable care. The tracing requirement for section 11 should be eliminated. Only the initial buyer from the issuer or underwriter should have the claim. The remedy should be rescission or actual loss from the failure to register or from the misstatement.

Substantial reform of these three parts of the securities laws would reduce the costs and delays in raising capital and contribute to economic gains and more jobs. The changes could be achieved while preserving meaningful investor protection and therefore should appeal to Democrats and Republicans alike.

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Appendix

A new approach to the public offering of securities would have these features:

1. An issuer would file a complete draft of a registration statement except for final pricing information in confidence with the SEC, receive one set of comments from the SEC staff within a fixed time period, publicly file a revised draft that is complete except for pricing information, wait at least three to five business days, file a complete registration statement, including all pricing information, and go effective immediately on this filing. As under section 5(a) of current law, no sales could occur until a registration statement became effective. The public draft and final registration statement would be available electronically from the SEC and issuer or underwriter as under current Rules 134, 424, 172, and 173.
   (a) Under current law, emerging growth companies and new issuers using Regulation A may file a non-public draft of the registration statement. See section 6(e)(1) of the Securities Act; Securities Act Rule 252(d). Securities Act rules are in 17 C.F.R. pt. 230. Current Rule 430(a) permits the use of a prospectus that is complete except for pricing information.
   (b) The proposed approach would eliminate the complexity of filing a registration statement without pricing information, going effective, and then filing a complete final statutory prospectus. See Rules 172, 430A, 424. It also would dispense with the need for a rule on immediate effectiveness of a registration statement. See Rule 462.

2. A company's obligation to make disclosures in the registration statement would be tailored to the company's size, as discussed in the main text. A small company would have limited disclosure obligations in line with the limited disclosure obligations they have now under parts of existing law, such as section 4(d)(3) or section 4A(b)(1)(A)-(H) of the Securities Act or a current Exchange Act Rule, 17 C.F.R. § 240.15c2-11(a)(5). Larger companies would need to make more extensive disclosures. As under current law with Form S-3, a company that was already a publicly reporting company would need to bring earlier disclosures current and add disclosures about the securities offering.

3. The law would not restrict any written or oral communications from the issuer or underwriter about a possible securities offering. At any time, the issuer and underwriter could make statements that would constitute an ''offer'' under current law. This would be a major change and would require amendments to section 5(b) and (c) and the definitions of ''offer'' and ''prospectus'' in the Securities Act. The change would allow the elimination of Rules 134, 135, 163, 163A, 164, 168, 169, and 433. Issuers, underwriters, and others would have liability as discussed in the main text for communications that were not complete and accurate.

4. A new approach would follow the current system of making efforts to notify potential buyers of the availability of the pre- or post-effective registration statement before an investor enters into a contract to buy.
   (a) In a communication from the issuer or underwriter to a potential buyer seeking an indication of interest before the registration statement is effective or seeking a decision to buy after the registration statement is effective, the issuer or underwriter would need to inform the person of the availability of the disclosure document at internet sites of the SEC, issuer, and underwriter. Current Rule 134 has a similar requirement.
   (b) If the issuer or underwriter received an offer to buy from a person who had not already received a communication about the availability of the registration statement, the issuer or underwriter would not be able to accept the offer to buy until the seller notified the person of the availability of the disclosure document and the person later confirmed the purchase order.

5. The issuer and underwriter would have no further obligation to deliver the final registration statement. This change would be consistent with current law under Rules 172, 173, and 174 and would allow repeal of sections 5(b)(2) and 4(a)(3) of the Securities Act and invalidation of Rules 172, 173, and 174.

6. Securities sold in a public offering would be freely tradable by one buyer to another. A new statute should make this explicit; section 4(a)(1) should be repealed, and the definition of a control person as an issuer in the underwriter definition in section 2(a)(11) of the Securities Act would be eliminated.

7. A company issuing securities should have an obligation to continue providing periodic disclosures to investors and the market for a minimum period of time, such as two years. A company could stop making periodic disclosures after two years if it ceased doing business or it had a small number of shareholders, such as fewer than 100. This would be similar to the current approach in sections 12(g) and 15(d) of the Exchange Act with some variations.

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Make It Easy for Startups to Sell Stock

Fewer regulations would increase access to capital and promote innovation

Andrew N. Vollmer (https://www.discoursemagazine.com/author/andrew-n-vollmer/)
September 21, 2020

Image credit: Aslan Alphan/Getty Images

he coronavirus might have dampened economic growth and activity, but the

The nation continues to produce entrepreneurs with new and creative business ideas. WhatsApp, Uber, and Venmo are examples of companies that started during difficult economic times. Nearly all entrepreneurs need capital to develop their ideas, and most of them borrow from family, banks, or credit card companies for initial financing.

Theoretically, startups can also turn to selling securities on stock markets to raise capital, but very few new businesses actually do this in the earliest stages. Apple, for instance, started in April 1976 and did not form a corporation until the following year. A major reason for the delay is that the securities world is a regulatory maze full of traps.

Policymakers can help eliminate the maze and give entrepreneurs more financing options. One of the best ways to do this is for Congress or the Securities and Exchange Commission (SEC) to add a new method of raising capital to the federal securities laws. This change could create a simple, lightly regulated method for early-stage companies to sell securities to raise a limited but reasonable amount of money. This would spur economic growth, productivity, and employment, and it could be done without sacrificing investor protection.

Currently, the four types of securities offerings relevant for our purposes are registered offers, Regulation A offerings, crowdfunding transactions, and Regulation D offerings. None of them afford startups an easy way to raise funds. Registered offers are costly, slow, and burdensome; Regulation A offerings have many of the same disadvantages. Crowdfunding transactions have layers of

regulatory requirements and restrictions, and private offerings under Regulation D depend on sales to investors who meet sophistication or wealth tests.

The fix I propose would sweep aside nearly all regulatory restrictions, conditions, and requirements for startups. It would exempt them from the rules for registered public offerings and from nearly all the other federal and state obligations on companies selling securities. Only a few rules would apply, and they would be aimed at helping a new business find funding without sacrificing investor protection.

The exemption would be limited to brand-new, small enterprises. Only companies with $250,000 or less of revenue in the preceding fiscal year would qualify. When a company began to earn more revenue and wanted additional capital, it would need to use one of the more traditional methods of selling securities or borrowing.

The proposed exemption would be limited to an aggregate offering price of $250,000 for securities during any 12-month period. This limit would be sufficient to fund a large number of startups, since many new businesses begin with only a small amount of money. Indeed, according to one study (https://poseidon01.ssrn.com/delivery.php?ID=1851190050710090061031060791150250740170470060410590021181050751060841 an average young firm has approximately $78,000 in financial capital. An SEC study (https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf) of the use of the crowdfunding exemption found that completed offers raised approximately $208,300 per offering.

The new exemption I propose would require no disclosures. It would allow each issuer and its investors to decide how much information to provide and what form disclosures should take. This feature would keep regulatory obligations to a minimum but not deprive investors of essential information. Most new businesses do not have much to disclose beyond the business plan and the background of the founders. In addition, most businesses find it easy to communicate with initial investors, since they are often a small group of family, friends, or savvy, risk-taking sponsors such as angel investors.

The streamlined approach of the new exemption might create a worry that scoundrels and fraudsters would take advantage to steal other people's money, but the SEC's experience with other exempted offerings has been that surges of misconduct have not occurred. The previously mentioned SEC study on the crowdfunding exemption did not find a significant amount of bad behavior. Additionally, when expanding the availability of the exemption for sales to accredited investors, the SEC said (https://www.sec.gov/rules/final/2020/33-10824.pdf) it had not seen evidence of widespread misconduct in exempt offerings.

Nonetheless, investors want assurances that the information they receive about an issuer and its securities is truthful. The new exemption would make available one of the private claims in the Securities Act, which allows a buyer to recover the amount paid for a security if the seller made a false or misleading statement and which relieves the buyer of many litigation burdens. State and federal anti-fraud laws would also apply.

The approach outlined here would help innovators with new business ideas meet their initial capital needs, which would aid the economic recovery from the COVID-19 recession. It would also offer many small investors the chance to get in on potentially profitable companies at the very beginning.

This is the fifth in a series of articles that will examine ways to help entrepreneurs who are seeking to start small businesses in the wake of the pandemic to access the capital they need. The *first article in this series* (https://www.discoursemagazine.com/economics/2020/08/27/financing-small-business-creation-in-the-wake-of-covid-19/) *provides an overview of the challenges facing would-be entrepreneurs in the coronavirus economy. The* *second article* (https://www.discoursemagazine.com/economics/2020/09/01/a-simple-plan/) *concerns offering small businesses guaranteed access to credit. The third article (https://www.discoursemagazine.com/economics/2020/09/09/the-felony-at-the-golf-club/) examines the rules governing investors in startups. The fourth article (https://www.discoursemagazine.com/economics/2020/09/14/revitalizing-small-businesses-in-post-pandemic-america/) concerns easing restrictions on lending by small banks. The sixth article (https://www.discoursemagazine.com/economics/2020/10/22/making-small-business-investment-easier/) argues that Congress should ease restrictions on peer-to-peer lending. The seventh article (https://www.discoursemagazine.com/economics/2020/11/09/surviving-the-winter/) proposes several reforms to the Small Business Administration. The eighth and final article*

(https://www.discoursemagazine.com/economics/2020/12/07/first-stop-digging/) urges governments to create a better environment for small businesses by reducing uncertainty and reopening the economy.

(http://www.facebook.com/sharer.php?u=https%3A%2F%2Fwww.discoursemagazine.com%2Feconomics%2F2020%2F09%2F21%2Fmake-it-easy-for-startups-to-sell-stock%2F)

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