The Wolf of All Streets: How Proposed Changes to The Meaning of "Accredited Investor" Could Derail Decades of Investor Protections.

The author of this comment possesses a juris doctor degree from Gonzaga University School of Law. Likewise, he is an attorney licensed to practice law in the state of Washington. The author has significant experience in securities law and has facilitated many Regulation D transactions. The author has previously been published for work in the area of consumer protection and antitrust law. Philosophically, the author is a proponent of law and economics jurisprudence, which seeks to apply economic theory to the practice of law. The author was assisted in the drafting of this comment by an individual possessing a master's degree in sociology from Bristol University.

Traditionally, accredited investors have been those persons whose financial sophistication, and ability to fend for themselves render the protection of the Securities Act's registration process unnecessary.[1] Accredited investors are classified in this way due to their net worth, knowledge, and experience in financial matters, or the amount of assets under management.[2] Famously, the classification of accredited investor has been criticized for being underinclusive, overinclusive, and paternalistic.[3]

However, the Equal Opportunity For All Investors Act, one of the many changes in securities regulations proposed by the JOBS ACT 4.0 (the "Act"), seeks to expand this narrow class of individuals; and, in so doing, open flood gates in the area of unregistered securities. Supporters of the bill argue that these flood gates will send a flow of capital to early-stage businesses and allow for greater financial democratization. Critics of the bill, however, believe that these flood gates will drown unsophisticated investors in a sea of fraud. Like most debates, both sides are correct in their own ways.

1. Beer and Bad Decisions: The Dangers Of Self-Verification

Presently, an individual can be accredited only if: 1) they have a net worth greater than $1,000,000, not including the individual's primary residence; 2) their individual income in each of the two most recent years exceeds $200,000, or joint income with their spouse exceeds $300,000 in each of those years; or, 3) they hold in good standing one or more professional certifications, designation, or credentials from an educational institution that the SEC has designated as qualifying an individual for accredited status.

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[1] *Morello v. White*, No. CV 16-04440 DMG (AJW), 2017 U.S. Dist. LEXIS 161373, at *4 (C.D. Cal. Sep. 5, 2017) (*citing* "SEC Staff Report" (Dec. 18, 2015) (report by the staff of the SEC) (footnote omitted)

[2] 15 U.S.C. § 77b(a)(15)(ii)

[3] Usha Rodrigues, Securities Law's Dirty Little Secret, 81 Fordham L. Rev. 3390, 3417-3425 (2013)

The changes in law proposed by the Equal Opportunity for all Investors Act would allow individuals to self-certify their accredited status.[4] This shifts the burden significantly. Presently, issuers seeking to use Regulation D to escape the regulatory and financial burdens of registration with the SEC must rely on the safe harbors created by Rules 506(c) and 506(b). While 506(c) requires reasonable steps to verify investor status, 506(b) allows for investor self-certification through a simple questionnaire, unless the issuer has reason to know that an investor is being dishonest in their responses. Rule 506(c) provides three "reasonable steps" to verifying the accredited status of investors: (1) the issuer itself can verify each investor's status, (2) the investor's accountant, lawyer, or another professional can verify the investor's status, or (3) the issuer can hire a third-party verification service to verify each investor's status.

Naturally, self-accreditation for 506(c) offerings would eliminate the need for issuers to take these reasonable steps. While this would present a significant advantage to issuers by reducing the financial and logistical burden of verifying investors, the proposed change in law would greatly diminish investor protections. Although 506(b) allows for self-accreditation, the rule offers significant procedural safeguards by forbidding general solicitation, requiring that unaccredited investors have sufficient experience to evaluate the risk,[5] and requiring greater disclosures by the issuer if there are investors who do not meet the sophistication levels required to be accredited.[6] These safeguards do not exist in 506(c) offerings. The proposed changes in law would allow issuers to reap the benefits of 506(c)'s general solicitation, while also evading the

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[4] The Act states "unless the issuer knows or has reckless disregard for whether the purchaser is not an accredited investor, obtaining a self-certification from the purchaser that the purchaser meets the income or net worth requirements of Rule 501 of Regulation D shall constitute reasonable steps to verify that purchasers of the security are accredited investors"

[5] 17 C.F.R. § 230.506(b)(2)(ii)

[6] 17 C.F.R. § 230.502(b)(1)-(2).

need to disclose important information and ensure that investors can burden the risk of their investment decisions.

The danger of this proposition is perhaps best explained through an analogy. Imagine, if you will, that grocery delivery services were allowed to deliver alcohol under these same guidelines. The service could freely advertise that it would deliver alcohol, and escape any liability by simply asking users to check a box stating that they are over 21. If such a law came into effect, these delivery services would certainly see an increase in cash flow; however, the nation would also see a rise in underage drinking. Just as a teenagers could reasonably be expected to lie in order to obtain alcohol, unsophisticated investors would feel the temptation to be dishonest in order to “get in on the ground floor” of an emerging business. While some may scoff at the idea of protecting individuals who would lie about their income or net worth in a misguided attempt to make risky investments, there also exists a possibility that certain uninformed investors could mistakenly waive their protections.

The current “reasonable steps” requirement allows attorneys, accountants, and third-party service providers to ensure that investors satisfy the parameters to be accredited. These professionals function as an additional safeguard to investors. Under a self-accreditation system, an individual may believe he is an accredited investor by miscalculating his net worth. In such a case, the simple act of checking a box would mean that this investor has waived his right to rescind his purchase of the security.

Likewise, human nature demonstrates that some individuals may seek to accredit themselves due to an incorrect self-perception. Self-verification theory is a social psychological theory, which states that an individual seeks to confirm their self-image in accordance with their

firmly held beliefs.[7] In this sense, “people may cling to their self-views through a strategy of self-verification – “seeing” nonexistent evidence... [and] interpret[ing] information in ways that reinforce their self-views”[8] In the context of accreditation, this means that an individual may act upon his desire to be viewed as wealthy and sophisticated by ignoring evidence or misinterpreting guidelines during his process of self-accreditation. This is particularly dangerous in the accreditation process due to the exclusion of primary residence from net worth calculations. An individual who has $200,000 in savings, and a primary residence valued at $800,000, may ignore the guidelines for accreditation in a subconscious attempt to maintain his self-perceived social status. By contrast, attorneys, accountants, and third-party service providers function as knowledgeable and objective evaluators.

2. *The Neutering of Disclosure Requirements and Blue Sky Laws*

The lack of disclosure requirements under 506(c), coupled with the proposed self-accreditation, would allow for the exact evils that the law has, thus far, sought to inhibit. Importantly, 506(b) allows up to 35 unaccredited investors to be involved in an offering, so long as certain disclosures are made. However, if no unaccredited investors participate in a 506(b) offering, this disclosure requirement does not apply. The reason for this is readily apparent. Accredited investors, due to their sophistication and natural aversion to risk, have created a market standard, wherein issuers are expected—though not required—to provide disclosures regarding the financials, key personnel, and road map of a business in which they will be investing. It is unlikely that less-sophisticated investors would demand the same disclosures from

[7] Lecky, P. (1945). Self-consistency: A theory of personality. New York: Island Press.

[8] Talaifar, Sanaz, and William B. Swann. "Self-verification theory." Encyclopedia of personality and individual differences (2020): 4813-4821.

issuers. Moreover, due to federal preemption, bad actors could take advantage of this lack of disclosure in manner similar to those investments which brought about blue sky laws.

"Blue sky" laws got their name from the case of *Hall v. Geiger-Jones Co*., 242 U.S. 539, 37 S. Ct. 217, 61 L. Ed. 480 (1916), in which the Supreme Court lauded the passage of state securities laws to curb "'speculative schemes which have no more basis than so many feet of blue sky;' or, as stated by counsel in another case, 'to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations.'"[9] While state-level blue sky laws prohibit bad actors from peddling low-quality investments, federal securities law focuses on disclosure as the primary safeguard for investors. Because the Securities Act preempts state securities law, fraudsters could potentially rely upon Rule 506(c) to evade the protections set forth by state law, while also circumventing the federal disclosure requirements.

3. A Good Idea With Erroneous Execution

In addition to allowing investors to self-accredit, the Act would expand the definition of accredited investor to include those who invest less than 10% of their net worth, income, or value of prior investments. The purpose of this change in law is clear: to democratize private offerings and allow everyday workers to invest in early-stage companies. While the positive intent of this change cannot be question, self-accreditation again rears its head as a significant risk-factor.

Under the Act, an issuer would only face liability—and an investor can only seek recourse—if the issuer knows, or shows reckless disregard for whether, the investor was not accredited. Because the Act does not require an issuer take reasonable steps to verify the amount that an individual can invest, issuers are best served by simply feigning ignorance. The Act

[9] *Klein v. George G. Kerasotes Corp*., 500 F.3d 669, 673 (7th Cir. 2007)

ultimately allows issuers to insulate themselves from liability by simply refusing to determine how much an individual is allowed to invest.

Take for example the defendants in *SEC v. Mahabub*, 343 F. Supp. 3d 1022, 1028 (D. Colo. 2018). In this case, an issuing company and its owner used cold-calls, high-pressure sales tactics and suggestions of a "get rich quick" scheme to defraud investors—many of whom were unaccredited investors who faced horrible financial difficulties as a result of the fraud. The issuer was held liable, in part, because it could not "prove that it reasonably believed all of the… investors were accredited" due to the issuer's failure to examine investors' answers to questionnaires. If self-accreditation were allowed, this would not be an outlier—it would be a common practice.

This is particularly concerning due to the nature of some transactions contemplated by the Act itself. While the Act goes to great lengths to create a regulatory structure for digital assets, it fails to recognize the potential for self-accreditations to derail the legislature's intent to protect investors. Digital assets are often viewed as significant investment opportunities due to their cultural popularity and technological significance; however, untoward issuers could easily pitch these assets in a "get rich quick" manner. Equally, without proper safeguards, unsophisticated, and lower-income investors may be persuaded to invest more than a safe amount. Yet, the issuer could avoid liability by simply doing exactly what the issuer in *Mahabub*—refusing to take reasonable steps to verify the status of investors.

Ultimately, the Act presents significant changes to securities law, many of which have the potential to increase funding for private companies, and present opportunities to new classes of investors. However, self-accreditation threatens to destroy the progress made in investor protection. Ultimately, the issues presented in this comment are easily solved by simply

removing the option for self-accreditation. Doing so would deter bad actors, and protect the new class of blue color investors.