AMENDING REGULATION D'S ACCREDITED-INVESTOR DEFINITION TO ALLOW NATURAL PERSONS TO OPT OUT OF UNWANTED REGULATORY PROTECTIONS

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INTRODUCTION

Should the Securities and Exchange Commission (SEC) expand the population of natural persons who qualify as accredited investors? Accredited investors can freely participate in unregistered securities offerings under Rule 506[1] of Regulation D,[2] while nonaccredited investors cannot. For companies seeking to raise capital, Rule 506 provides a lightly regulated alternative to initial public offerings ("IPOs") and other registered offerings, but most Americans are excluded from investing in Rule 506 offerings. Should the SEC soften that exclusion and allow more individuals to participate in what has become the country's largest capital-raising market?[3]

Securities investing is an inherently risky endeavor that requires high-quality information for investors to make thoughtful decisions.[4] Because issuers are better informed about their risks and rewards than investors, federal securities law protects investors by imposing substantial disclosure requirements on issuers that sell their securities in public offerings.[5] Such issuers must register their transactions with the SEC,[6] which includes publicly filing a detailed disclosure document,[7]

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1. 17 C.F.R. § 230.506 (2024).
2. 17 C.F.R. §§ 230.500-.508 (2024).
3. *See* U.S. SECURITIES & EXCHANGE COMMISSION (SEC) OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT: FISCAL YEAR 2024 14-15 (2024) [hereinafter 2024 SMALL BUSINESS CAPITAL FORMATION REPORT], https://www.sec.gov/files/2024-oasb-annual-report-print.pdf; SEC OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT: FISCAL YEAR 2023 14 (2023) [hereinafter 2023 SMALL BUSINESS CAPITAL FORMATION REPORT], https://www.sec.gov/files/2023-oasb-annual-report-print.pdf.
4. *See* discussion *infra* Part I.
5. *See* Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 33-10649, 84 Fed. Reg. 30460, 30460 (June 18, 2019) ("The purpose of registration is to provide investors with full and fair disclosure of material information so that they are able to make their own informed investment and voting decisions.").
6. Securities Act of 1933 ("Securities Act") § 5, 15 U.S.C. § 77e.

called a registration statement, and committing to produce periodic public disclosures thereafter[8] (the "Registered Path"). The Registered Path is long, expensive, and heavily regulated, but an issuer's payoff is substantial as it can sell its securities to anyone, including the most vulnerable investors.[9]

For many issuers, however, the Registered Path's payoff does not justify its burden, so they choose to raise capital through unregistered offerings. When Congress passed the Securities Act of 1933[10] (the "Securities Act") and created the federal registration process, it also exempted certain securities and transactions from registration "where there is no practical need for [registration] or where the public benefits are too remote."[11] Rule 506, which is the most important of the capital-raising exemptions, offers issuers a lightly regulated path for selling their securities that is much faster and cheaper than the Registered Path. But there is a catch: an issuer cannot sell its securities to just anyone in a Rule 506 transaction. The Rule 506 market is fundamentally restricted to accredited investors.[12]

Federal securities law allows accredited investors to opt out of the Registered Path's investor protections because the SEC views them as having "sufficient knowledge and expertise to participate in investment opportunities that do not have the rigorous disclosure and procedural requirements, and related investor protections, provided by registration under the Securities Act."[13] Institutional investors such as banks, registered broker-dealers, investment advisers, insurance companies, and certain investment funds qualify as accredited investors.[14] Some natural persons can also qualify as accredited investors,[15] including, most importantly, those who meet wealth thresholds. Individuals with a

7. Securities Act § 5(c), 15 U.S.C. § 77e(c).

8. Securities Exchange Act of 1934 ("Exchange Act") § 13, 15 U.S.C. § 78m; Exchange Act § 15(d)(1), 15 U.S.C. § 78o(d)(1).

9. *See* Usha Rodriques, *Financial Contracting with the Crowd*, 69 EMORY L.J. 397, 407 (2019).

10. 15 U.S.C. §§ 77a et seq.

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

12. *See infra* note 31 and accompanying text.

13. Amending the "Accredited Investor" Definition, Securities Act Release No. 33-10824, 85 Fed. Reg. 64234, 64235 (Aug. 26, 2020).

14. Regulation D Rule 501(a)(1)-(3), 17 C.F.R. §§ 230.501(a)(1)-(3) (2024).

15. Regulation D Rule 501(a)(4)-(6), (10), & (11), 17 C.F.R. §§ 230.501(a)(4)-(6), (10), (11) (2024).

net worth exceeding $1 million are accredited investors,[16] and so too are individuals with annual income exceeding $200,000 (or $300,000 jointly with a spouse or spousal equivalent).[17] Wealth is meant to serve as a proxy for financial sophistication and the ability to withstand an investment loss,[18] but it is an imperfect approximation, at best.[19]

Getting the accredited-investor definition right for natural persons is critically important, and the SEC is currently looking at the issue.[20] The definition serves as the dividing line between the individuals who can, or cannot, freely participate in the Rule 506 market. Historically, where a company was in its lifecycle played an important role in how it raised capital. Early-stage companies would generally raise small amounts of money in Rule 506 offerings.[21] As such companies matured and sought to raise significant capital, they would conduct IPOs, list their stocks on a national securities exchange, and become public companies.[22] Companies would IPO early enough in their lifecycle to allow public investors to participate in much of the high-growth/high-return phase. Over the last two decades, that pattern has dramatically changed with many companies choosing to wait longer to IPO or choosing to avoid the public market altogether.[23] This pattern change has increased the Rule 506 market's importance as it has become the United States' largest capital-raising market (accounting for 50.9% of the capital raised in all U.S. securities offerings for the two-year period

16. Regulation D Rule 501(a)(5), 17 C.F.R. § 230.501(a)(5) (2024).

17. Regulation D Rule 501(a)(6), 17 C.F.R. § 230.501(a)(6) (2024).

18. Release No. 33-10824, *supra* note 13, at 64235.

19. *See generally id;* Alison Herren Lee, Comm'r, SEC, *Statement on the Proposed Expansion of the Accredited Investor Definition* (Dec. 18, 2019) [hereinafter *Comm'r Lee Accredited Investor Statement*], https://www.sec.gov/newsroom/speeches-statements/statement-lee-2019-12-18-accredited-investor.

20. SEC, REVIEW OF THE "ACCREDITED INVESTOR" DEFINITION UNDER THE DODD-FRANK ACT 53 (Dec. 14, 2023) [hereinafter 2023 SEC STAFF REPORT], https://www.sec.gov/files/review-definition-accredited-investor-2023.pdf.

21. *See generally* STEVEN T. MNUCHIN & CRAIG S. PHILLIPS, U.S. DEPT. OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS, REPORT TO PRESIDENT DONALD J. TRUMP, EXECUTIVE ORDER 13772 ON CORE PRINCIPLES FOR REGULATING THE UNITED STATES FINANCIAL SYSTEM 21 (Oct. 2017), https://home.treasury.gov/system/files/136/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

22. *See id.*

23. *See* discussion *infra* Part I.

from July 1, 2022 to June 30, 2024[24])and the preferred option for many of the country's highest-growth entrepreneurial companies. Individuals who want to build wealth by investing in the growth phase of these entrepreneurial companies (subject to accompanying risk) must be accredited investors, or they will be turned away. As Part II explains, Rule 506 consists of two separate exemptions: Rule 506(b) and Rule 506(c).

> **1.** **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 nonaccredited investors who meet sophistication requirements.[25] Rule 506(b) mandates the issuer furnish extensive disclosure to any nonaccredited investors who purchase securities in the offering[26] and prohibits using general solicitations or advertising to market the offering.[27] If the issuer limits its Rule 506(b) sales only to accredited investors, there are no mandatory disclosure requirements.[28]
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> **2.** **Rule 506(c)** allows an issuer to use general solicitations or general advertising to sell an unlimited dollar amount of securities to an unlimited number of accredited investors provided all the buyers are accredited investors and the issuer takes reasonable steps to verify that they are.[29] Because there are no nonaccredited-investor purchasers, there are no mandatory disclosure requirements.[30]

Technically, only Rule 506(c) completely excludes nonaccredited investors. However, the mandatory disclosure cost that accompanies nonaccredited investors in a Rule 506(b) transaction causes the vast

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24. *See* 2024 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14-15 (Rule 506 offerings accounted for $2.01 trillion of the $4.29 trillion of capital raised in U.S. securities offerings between July 1, 2023 and June 30, 2024); 2023 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14 (Rule 506 offerings accounted for $2.87 trillion of the $5.29 trillion of capital raised in U.S. securities offerings between July 1, 2022 and June 30, 2023).

25. Regulation D Rule 506(b)(2)(i)-(ii), 17 C.F.R. §§ 230.506(b)(2)(i)-(ii) (2024); Regulation D Rule 501(e), 17 C.F.R. § 230.501(e) (2024).

26. Regulation D Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2024); Regulation D Rule 502(b), 17 C.F.R. § 230.502(b) (2024).

27. Regulation D Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2024); Regulation D Rule 502(c), 17 C.F.R. § 230.502(c) (2024).

28. Regulation D Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) (2024).

29. Regulation D Rule 506(c)(1)-(2), 17 C.F.R. §§ 230.506(c)(1)-(2) (2024).

30. Regulation D Rule 506(c)(1), 17 C.F.R. § 230.506(c)(1) (2024).

majority of issuers to exclude any nonaccredited investors from their Rule 506(b) offerings. The SEC estimates that only 6% of Rule 506(b) transactions "initiated during 2009 through 2022 involved non-accredited investors."[31]

The Rule 506 market, therefore, is fundamentally limited to accredited investors. If the definition is under-inclusive (i.e., it leaves out investors with the sophistication to understand the investment and its risks), it may unintentionally exacerbate U.S. wealth inequality[32] since it limits a large and potentially valuable class of investments to the wealthy. Recognizing that the wealth thresholds may be under-inclusive, the SEC amended the accredited-investor definition in 2020 (the "2020 Amendments") to include two new categories of natural persons "that qualify as accredited investors irrespective of their wealth, on the basis that such investors have demonstrated the requisite ability to assess an investment opportunity."[33] One of the new categories is for individuals holding certain SEC-designated credentials[34] and the other is for "knowledgeable employee[s]" of a private fund for investments in that fund.[35] Even with these new categories, the accredited-investor definition may still be under-inclusive and deny many thoughtful individuals the ability to choose for themselves how they wish to invest their own money.

At the same time, some worry that the definition is over-inclusive (i.e., it includes individuals who lack the sophistication to understand the investment and its risks or the ability to withstand an investment loss). Because the wealth thresholds were established in the 1980s and have not been indexed to inflation, they no longer have the same meaning they once did. Largely due to inflation, the SEC estimates that the number of U.S. households that qualify as accredited investors based on the wealth thresholds has grown from 1.8% in 1983 to 18.5% in 2022.[36] If the wealth thresholds remain unchanged, the SEC estimates that 65.9% of households would qualify as accredited investors by 2052.[37] There is also evidence that the net-worth threshold may capture

31. 2023 SEC STAFF REPORT, *supra* note 20, at 37.
32. MNUCHIN & PHILLIPS, *supra* note 21, at 27.
33. Release No. 33-10824, *supra* note 13, at 64235.
34. Regulation D Rule 501(a)(10), 17 C.F.R. § 230.501(a)(10) (2024).
35. Regulation D Rule 501(a)(11), 17 C.F.R. § 230.501(a)(11) (2024).
36. 2023 SEC STAFF REPORT, *supra* note 20, at 23-24.
37. *Id.* at 27-28.

older investors who have accumulated substantial life savings for retirement but lack the sophistication, possibly due to cognitive decline, to thoughtfully invest in the lightly regulated Rule 506 market.[38] An over-inclusive definition may subject vulnerable individuals to an inappropriate level of risk.

This author believes that both concerns are likely true; the current accredited-investor definition is under-inclusive and over-inclusive at the same time. This article proposes a solution that allows the SEC to address more aggressively the over-inclusion problem while simultaneously reducing the under-inclusion problem. Currently, the accredited-investor definition establishes a bright dividing line for investing in the Rule 506 market. Investors who satisfy the definition fall on one side of the line and are "in." Investors who fail to satisfy the definition fall on the other side of the line and are "out," regardless of their personal desires. Rather than treat the accredited-investor definition as a bright line for determining who can invest in the Rule 506 market—particularly when we know the dividing line is imperfect—this article suggests making the definitions for natural persons default rules and allowing individuals a path to opt out of the SEC's regulatory protections. Making the accredited-investor definition a waivable default rule allows the SEC to protect potentially vulnerable investors by clearly communicating when the Rule 506 market may be unsuitable for them. The SEC could even raise the bar on who automatically qualifies as accredited. At the same time, competent individuals who disagree with the SEC's concerns—and who are most familiar with their own financial sophistication, risk tolerance, and finances—could voluntarily choose to be accredited investors and opt out of being shielded from risky investments.

This proposal is a significant departure from how federal securities law and the SEC has historically regulated the Rule 506 market. Rule 506 has always treated the Rule 506 market as being so hazardous that most individuals must be shielded from it regardless of their personal desires. Rule 506 has never given a nonaccredited investor the option of just saying "no thank you" to being protected. Just as investing in the Rule 506 market involves substantial risks, so does making significant

38. *See, e.g.*, Michael Finke et al., *The Unsophisticated "Sophisticated": Old Age and the Accredited Investors Definition*, FIN. PLAN. REV., May 2021, https://doi.org/10.1002/cfp2.1114.

regulatory changes. To reduce that risk, this article suggests phasing in the proposal in two stages:

> 1. **Stage 1—Start with Rule 506(b).** During Stage 1, the opt-out proposal would only apply to transactions conducted under Rule 506(b). Because Rule 506(b) does not allow general solicitations, the pool of nonaccredited investors who could opt out will be much shallower. The pool is effectively limited to individuals who have a pre-existing, substantive relationship[39] with the issuer (or a person acting on its behalf). This close relationship between the issuer (or its agents) and the nonaccredited investors should also reduce the potential for predatory actors bringing nonaccredited investors into unsuitable deals.
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> 2. **Stage 2—Include Rule 506(c).** Stage 1 would serve as a proof-of-concept. Assuming no serious problems occur during Stage 1, Stage 2 would follow a reasonable time after Stage 1 is introduced. During Stage 2, the opt-out proposal would expand to include both Rule 506(b) and Rule 506(c) transactions.

Some may worry that expanding the population of investors who can invest in the Rule 506 market will lead to inordinate risk and fraud for currently nonaccredited investors. However, it is important to note that reducing government regulation does not mean that investors are left unprotected. The Rule 506 market has spent decades developing private solutions to address the very problems the SEC wants to shield nonaccredited investors from, and those private solutions are an important reason why the Rule 506 market has grown and flourished.[40] Existing private solutions may adapt to absorb an expanded population of accredited investors and even more private solutions may develop in the future.

This article proceeds as follows: Part I explores the information asymmetry problem that plagues all securities markets and the government's approach to improving that problem for the Registered Path. Part II provides an overview of Rule 506(b) and Rule 506(c) and the accredited-investor definition. Part III examines the difference between government solutions to market problems and private solutions, and the critical role that private solutions have played in growing the Rule 506 market into its current, dominant position. Part IV considers

39. *See infra* notes 116-19 and accompanying text.
40. *See* discussion *infra* Parts III and V.E.

current critiques of the accredited-investor definition and its under- and over-inclusion shortcomings. Part V sets forth a proposal to allow natural persons to qualify as accredited investors by waiving their right to be treated as nonaccredited investors. It also explains why the reasons for heavily regulating the Registered Path do not justify prohibiting nonaccredited investors from participating in the Rule 506 market if they choose to opt out of being protected. Finally, Part VI offers a conclusion.

I. REGULATING THE REGISTERED SECURITIES MARKET

A securities investment returns value through the future cashflows it generates for investors.[41] Predicting those future cashflows requires information about the issuer, including information about its business strategies, financial performance, risks, and management, among other factors. This is why information is often said to be the "lifeblood" of securities markets.[42] In an ideal securities market, fully informed buyers and sellers negotiate at arm's length (and at low transaction costs) to determine whether a transaction makes sense. The problem with this ideal setting is that issuers typically have much better information about their future cashflows than investors, which poses two fundamental problems for securities offerings:

> 1. **Investors can be cheated.** Issuers can use their informational advantage to sell overpriced securities to investors. This is particularly true for unsophisticated investors.
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> 2. **Sophisticated investors will discount the stock price.** Sophisticated investors should appreciate their informational disadvantage and treat it as a "cost" when valuing securities. They could attempt to identify deficient disclosers and pay less for their

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41. *See* JANET KIHOLM SMITH & RICHARD L. SMITH, ENTREPRENEURIAL FINANCE: VENTURE CAPITAL, DEAL STRUCTURE & VALUATION 354 (2d ed. 2019).

42. Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC's Role in Regulating Information*, 55 BUFF. L. REV. 1, 1 (2007); John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 879 (2005) [hereinafter Orcutt, *Improving the Efficiency of the Angel Finance Market*]; Arthur Levitt, Chairman, SEC, Remarks at the Economic Club of New York, *Quality Information: The Lifeblood of Our Markets* (Oct. 18, 1999) https://www.sec.gov/news/speech/speecharchive/1999/spch304.htm.

> shares. Unfortunately, identifying deficient disclosers is difficult. When it is impossible to distinguish honest disclosers from dishonest ones, sophisticated investors are likely to discount the securities prices for all issuers.[43] Honest issuers are punished, as they must sell securities at an unwarranted discount. If the information asymmetries are too serious, a "lemons problem" can arise and threaten the entire market.[44]

Investors can engage in costly information gathering and assessment efforts to overcome their informational disparities, but doing so may be hampered by collective action problems that render the effort uneconomical for individual shareholders.[45] The cost of gathering/assessing the information may be justified by the benefit to the shareholders as a whole, but such cost is greater than the benefit that would be received by any one shareholder (or potential shareholder).[46] Without a mechanism to spread the information gathering/assessment costs across the shareholders (or potential shareholders) collectively, a suboptimal level of such activities will take place.

Reducing information asymmetries is the most common reason given for regulating securities transactions.[47] Doing so protects investors (particularly unsophisticated ones), while simultaneously improving the cost of capital for honest issuers. Federal securities law tries to reduce the information asymmetries for the Registered Path through its elaborate, mandatory disclosure system. The system mandates and specifies issuer disclosure before securities can be issued and periodically after issuance.

The Securities Act governs the time-of-issuance disclosure. Absent an exemption, Securities Act section 5[48] generally prohibits offering

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43. *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 272 (2003).

44. Asymmetric information's effect on markets and the resulting "lemons problem" can be traced back to George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 490, 495 (1970).

45. *See* Choi & Fisch, *supra* note 43, at 278; *see also* Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 45-46 (2004) [hereinafter Choi, *Framework for Regulation*].

46. Choi & Fisch, *supra* note 43, at 278.

47. *See e.g.*, JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 5-11(10th ed. 2022); Keven S. Haeberle & M. Todd Henderson, *Making a Market for Corporate Disclosure*, 35 YALE J. ON REGUL. 383, 384 (2018).

48. 15 U.S.C. § 77e.

securities unless a registration statement has been filed with the SEC[49] and prohibits selling securities until that registration statement goes effective.[50] Per authority granted by Congress,[51] the SEC has developed a comprehensive set of registration-statement disclosure requirements over the years.[52] The registration statement must include, among other things, a prospectus, an in-depth summary of the issuer's business,[53] audited financial statements[54] (coupled with management's analysis of the issuer's financial condition and results of operations[55]), risk factors,[56] and identification of the issuer's officers and directors and detailed information about their compensation.[57]

The Securities Exchange Act of 1934[58] (the "Exchange Act") governs post-issuance disclosure. Once the issuer's registration statement goes effective, the issuer must also become an Exchange Act reporting company[59] and submit to ongoing, periodic reporting requirements (such as an annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K).[60] In addition to ongoing disclosure requirements, reporting companies must also comply with a long list of additional obligations, including federal proxy rules,[61] the Sarbanes-Oxley Act[62] (including its heightened internal control

49. Securities Act § 5(c), 15 U.S.C. § 77e(c).

50. Securities Act § 5(a)(1), 15 U.S.C. § 77e(a)(1).

51. Securities Act § 7(a)(1), 15 U.S.C. § 77g(a)(1).

52. Registration statement content primarily is governed by the various Securities Act Forms, 17 C.F.R. pt. 239 (2024), Regulation S-K, 17 C.F.R. pt. 229 (2024), and Regulation S-X, 17 C.F.R. pt. 210 (2024).

53. Regulation S-K Item 101, 17 C.F.R. § 229.101 (2024).

54. Regulation S-X Rule 3-01(a), 17 C.F.R. § 210.3-01(a) (2024); Regulation S-X Rule 3-02(a), 17 C.F.R. § 210.3-02(a) (2024).

55. Regulation S-K Item 303, 17 C.F.R. § 229.303 (2024).

56. Regulation S-K Item 105, 17 C.F.R. § 229.105 (2024).

57. Regulation S-K Items 401-402, 17 C.F.R. §§ 229.401-.402 (2024).

58. 15 U.S.C. §§ 78a et seq.

59. Exchange Act § 12(a), 15 U.S.C. § 78l(a); Exchange Act § 15(d), 15 U.S.C. § 78o(d).

60. For Section 12 reporting companies, Exchange Act Section 13(a), 15 U.S.C. § 78m(a), establishes the ongoing, periodic reporting requirements. For Section 15(d) reporting companies, Exchange Act Section 15(d), 15 U.S.C. § 78o(d), establishes the ongoing, periodic reporting requirements.

61. Exchange Act § 14, 15 U.S.C. § 78n.

62. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of U.S.C. titles 11, 15, 28, and 29).

requirements),[63] the Foreign Corrupt Practices Act,[64] and "short swing" insider trading rules.[65] Becoming a reporting company may also subject the issuer's shareholders to federal disclosure requirements.[66]

Reducing information asymmetries to protect investors and increase market efficiency is a worthy undertaking, but it comes at a cost. Complying with the Securities Act's registration requirements and the Exchange Act's reporting-company obligations can be very expensive and burdensome. For a first-time registrant, the Securities Act registration process usually takes more than 6 months[67] and can easily cost millions of dollars.[68] And the Exchange Act obligations continue the costs into the future, potentially in perpetuity. The fact that regulatory obligations are expensive is not itself problematic. Rather, problems arise when the regulations impose costs that exceed the regulatory benefits, in which case the regulations are cost ineffective.

When regulatory services become significantly cost ineffective, regulated parties will reasonably seek to avoid the regulation. This appears to be what is happening in the United States "as much of the action in capital markets has moved to private offerings."[69] SEC Commissioner Allison Herren Lee notes that "[p]erhaps the single most significant development in securities markets in the new millennium has been the explosive growth of private markets."[70] Exempt offerings, rather than registered offerings, have now become the dominant

63. *See, e.g.*, Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262.

64. Foreign Corrupt Practices Act of 1977, Pub. L. 95-213, 91 Stat. 1494, 15 U.S.C. §§ 77dd-1 et seq.

65. Exchange Act § 16, 15 U.S.C. § 78p.

66. *See, e.g.*, Exchange Act §§ 13(d) and 13(g), 15 U.S.C. § 13m(d), 13m(g).

67. Reanna Zuniga, *The IPO Process Explained*, PITCHBOOK BLOG (last updated Aug. 1, 2024), https://pitchbook.com/blog/ipo-process-explained.

68. *See generally*, PWC, *Considering an IPO? First, Understand the Costs*, https://www.pwc.com/us/en/services/consulting/deals/library/cost-of-an-ipo.html (last visited Jan. 16, 2025).

69. Thaya Brook Knight, *Policy Analysis: Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors*, CATO INST. CTR. FOR MONETARY & FIN. ALTS. 3 (Feb. 9, 2018), https://www.cato.org/policy-analysis/moneys-no-good-here-how-restrictions-private-securities-offerings-harm-investors.

70. Alison Herren Lee, Comm'r, SEC, *Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy* (Oct. 12, 2021), https://www.sec.gov/newsroom/speeches-statements/lee-sec-speaks-2021-10-12#_ftnref1.

fundraising pathway for U.S. issuers.[71] For the five-year period running from July 1, 2019 to June 30, 2024, 72.1% of the capital raised in the United States was raised through exempt offerings.[72]

Table 1: Registered vs. Exempt Offerings for the 12-Months Ended June 30, 2020 – 2024[73]

	2020	**2021**	**2022**	**2023**	**2024**	**5-Year Total**
Registered offerings	$1.6 trillion	$1.7 trillion	$1.2 trillion	$1.1 trillion	$1.2 trillion	$8.8 trillion
Exempt offerings	$2.7 trillion	$3.3 trillion	$4.5 trillion	$4.2 trillion	$3.1 trillion	$17.7 trillion
Percentage of offerings that were exempt	63.1%	66.0%	78.4%	78.9%	71.2%	72.1%

There has never been any question that the Registered Path and its accompanying obligations is not the right capital-raising option for all issuers. For a young startup seeking to quickly raise a few million dollars of capital (or less), the Registered Path has always been too expensive and burdensome. However, as startups grow and become more mature, they have historically progressed to the registered market and conducted IPOs, listed their stock on a national securities exchange,

71. *See id. See also* Michael J. Mauboussin & Dan Callahan, *Public to Private Equity in the United States: A Long-Term Look*, Morgan Stanley Counterpoint Global Insights 4 (Aug. 4, 2020) ("Further, companies have raised more money in private markets than in public markets in each year since 2009.").

72. *See infra* Table 1.

73. 2024 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14-15; 2023 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14; SEC. OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT: FISCAL YEAR 2022 13 (2022) [hereinafter 2022 SMALL BUSINESS CAPITAL FORMATION REPORT], https://www.sec.gov/files/2022-oasb-annual-report.pdf; SEC OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT: FISCAL YEAR 2021 11 (2021) [hereinafter 2021 SMALL BUSINESS CAPITAL FORMATION REPORT], https://www.sec.gov/files/2021-oasb-annual-report.pdf; SEC OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT: FISCAL YEAR 2020 11 (2020) [hereinafter 2020 SMALL BUSINESS CAPITAL FORMATION REPORT], https://www.sec.gov/files/2020-oasb-annual-report.pdf.

and become public companies,[74] thus giving the entire public the ability to invest in the startups' further growth. That model has dramatically changed over the last twenty years, as companies that once flocked to IPOs and the public market now actively seek to avoid it.

The U.S. IPO market has been depressed since 2001.[75] Far fewer companies conduct IPOs in the 2000s compared to the 1990s. The annual number of IPOs averaged 436 from 1991 through 2000, with the peak occurring in 1996 at 677 IPOs.[76] From 2001 to 2024, the annual number of IPOs averaged 114, and for the last ten years (2015 to 2024) the average was 119.[77] The last three years, 2022 - 2024, were particularly rough IPO years as there were only 38, 54, and 72 IPOs, respectively.[78] The IPOs that do occur now tend to be for larger, more mature companies. The biggest drop in IPOs has been for small ones (those raising less than $100 million),[79] which are typically conducted by smaller companies. One study found that "[i]n the 1990s, small IPOs made up 27% of all capital raised in the public market, whereas in the period from 2000 to [2017] they have represented only 7% of all capital raised."[80] As IPOs have become bigger, so too has the median age for IPO issuers. From 1980 to 1989, the median age for IPO issuers was 8 years, and it was 9 years from 1990 to 1998.[81] However, from 2001 to 2024 the median age rose to 11 years.[82] Unicorns, or private companies with a valuation exceeding $1 billion, used to be rare. One possible reason is that companies reaching that size were eager to IPO. However, that is no longer the case as there are now more than 700 unicorns in the United States.[83]

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74. *See* MNUCHIN & PHILLIPS, *supra* note 21, at 21, 25-26.

75. *See* Jay R. Ritter, *Initial Public Offerings: Updated Statistics* 3-4 (Jan. 9, 2025), https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf; *see infra* Figure 1.

76. *Id.*

77. *Id.*

78. *Id.*

79. Marshall Lux & Jack Pead, *Hunting High and Low: The Decline of the Small IPO and What to Do About It* 7-8 (Mossavar-Rahmani Cent. for Bus. and Gov't, Harvard Kennedy Sch., Working Paper No. 86, 2018), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/86_final.pdf.

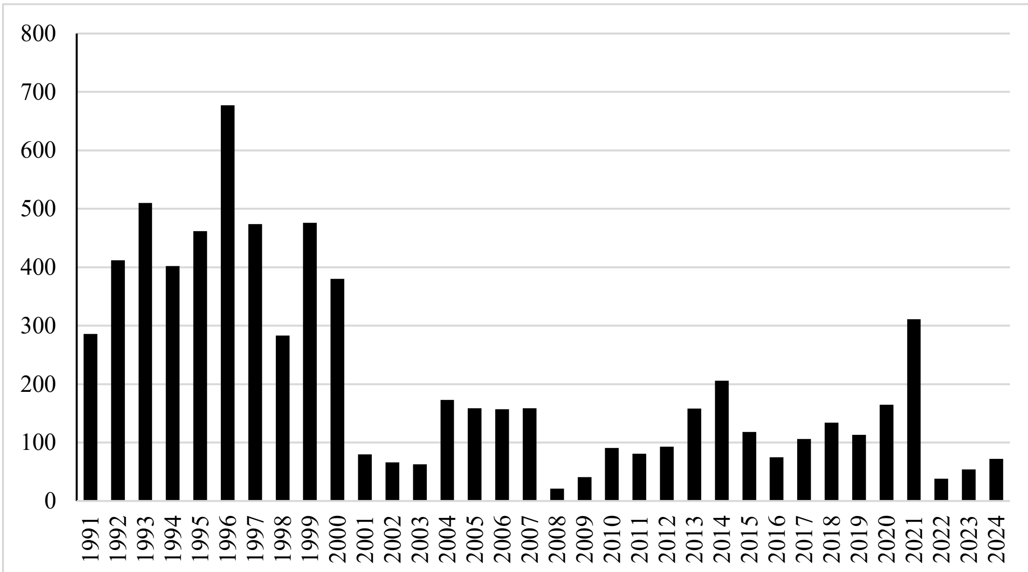
80. *Id.* at 8.

81. Ritter, *supra* note 75, at 12.

82. *Id.*

83. Hurun Rsch. Inst., *Global Unicorn Index 2024*, HURUN (Apr. 9, 2024), https://www.hurun.net/en-US/Info/Detail?num=9K1G2SK5X7CX.

Figure 1: Number of IPOs in the United States (1991 – 2024) [84]



Source: Jay R. Ritter, Initial Public Offerings: Updated Statistics

As the number of IPOs has decreased, so too has the number of publicly traded companies listed on U.S. markets.[85] The number of domestic publicly traded companies peaked in the United States in 1996 at 8,090 companies and subsequently dropped to 4,642 companies in 2022—a 43% drop.[86] A big driver of this precipitous drop in listed companies has been the "disappearance of small firms on U.S. exchanges."[87] Older and bigger forms now dominate the listed-company pool. The average market capitalization for a listed company increased from about $2 billion in 1997 to $6 billion in 2016,[88] while the average age increased from 12 years in 1997 to 20 years in 2016.[89]

84. Ritter, *supra* note 75, at 3-4.

85. *See Listed Domestic Companies, Total - United States*, WORLD BANK OPEN GRP. DATA https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US (last visited Jan. 16, 2025).

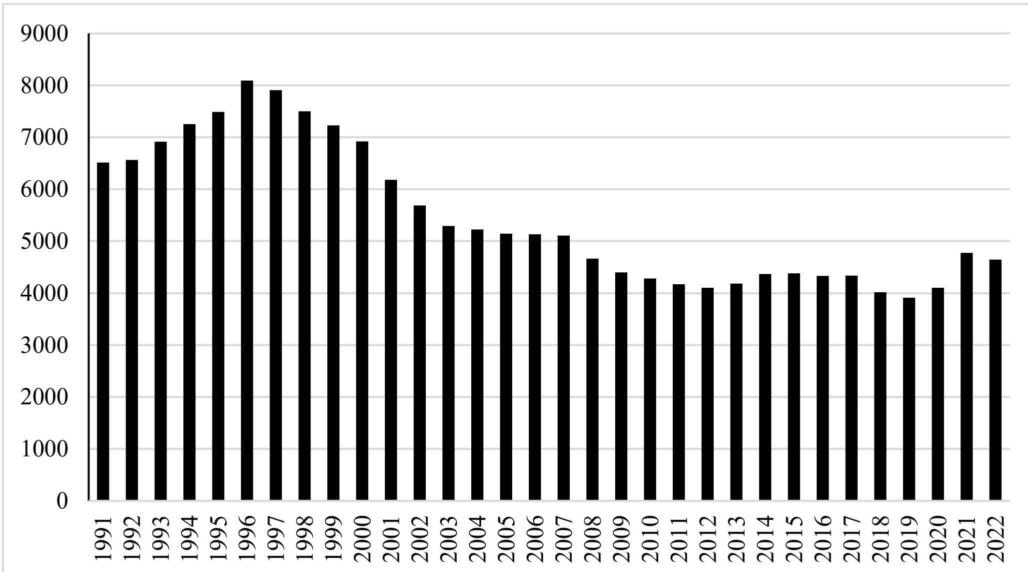
86. *See id.*

87. Craig Doidge et al., *Eclipse of the Public Corporation or Eclipse of the Public Markets?* 5 (NBER, Working Paper No. 24265, 2018), https://www.nber.org/system/files/working_papers/w24265/w24265.pdf.

88. *Id.* at 5 and 19.

89. *Id.* at 5.

Figure 2: Number of Domestic Publicly Traded Companies on U.S. Markets (1991 – 2022) [90]



Many question whether the registered market's high regulatory costs have encouraged the depressed IPO market, the decreased number of listed companies, and the overall trend of large companies remaining private longer.[91] A 2017 U.S. Department of Treasury Report on the U.S. capital markets, for example, considered why companies may be avoiding the public markets:

> [I]t is challenging to identify specific causal factors that contribute to decisions on whether to go public.
>
> However, increased disclosure and other regulatory burdens may influence a decision to obtain funding in the private markets for a company that might have previously sought to raise capital in the public markets.

90. *Listed Domestic Companies, Total - United States*, *supra* note 85.

91. *See, e.g.*, Michaels Ewens et al., *Regulatory Costs of Being Public: Evidence from Bunching Estimation*, 153 J. FIN. ECONS. 1, 1-4 (2024); *The Declining Number of Public Companies and Mandatory Reporting Requirements*, ERNST & YOUNG 2-3 (June 2022), https://accf.org/wp-content/uploads/2022/06/EY-ACCF-The-declining-number-of-public-companies-and-mandatory-reporting-requirements-June-2022.pdf; MNUCHIN & PHILLIPS, *supra* note 21, at 25-26.

> [. . .]
>
> During Treasury's outreach efforts, stakeholders frequently highlighted the cumulative impact of new regulations and legal developments affecting public companies since the Sarbanes-Oxley Act, rather than any individual regulatory action.[92]

Congress tried to address some of the regulatory-cost concerns for the public market when it passed the Jumpstart Our Business Startups Act of 2012[93] (the "JOBS Act"). Among other things, the JOBS Act sought to streamline the IPO process and reduce reporting-company obligations for many companies.[94] IPOs immediately spiked after the passage of the JOBS Act. There were 158 IPOs in 2013 and 206 in 2014, compared to an average of 65 IPOs per year from 2008 through 2012.[95] But that increase proved to be short-lived. Outside of the brief surge of special purpose acquisition companies (SPACs)[96] in 2020 and 2021, IPO activity has remained "relatively muted"[97] since 2014.[98] Regarding company listings, they have not shown much improvement since 2012, although the downward trend seems to have stopped.[99]

The idea that aspects of the federal securities regulatory system may be out of sync with the needs of issuers and investors should not be all that surprising. The federal securities regulatory system provides a variety of services (such as rulemaking, standard-setting, monitoring, and supervision) to various securities market stakeholders.[100] However,

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92. MNUCHIN & PHILLIPS, *supra* note 21, at 26.

93. Jumpstart Our Business Startups Act of 2012 ("JOBS Act"), Pub. L. No. 112-106, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C.).

94. *See* JOBS Act §§ 101-108, 126 Stat. at 307-15.

95. Ritter, *supra* note 75, at 3.

96. John L. Orcutt, *A Signal for Honest Management Forecasts: Expanding the PSLRA Safe Harbor to IPO Issuers with Extended Lockup Periods*, 6 BUS. & FIN. L. REV. 1, 7 (2022) ("SPAC IPOs differ substantially from traditional IPOs. A SPAC is a shell company created to raise capital in an IPO solely in anticipation of identifying and acquiring an existing private company. The private-company acquisition, commonly referred to as a 'de-SPAC transaction,' takes place through a business combination. If successful, the de-SPAC allows the private company to become a reporting company with publicly traded shares without having to conduct a traditional IPO.")

97. MNUCHIN & PHILLIPS, *supra* note 21, at 29.

98. *See* Figure 1 *supra.*

99. *See* Figure 2 *supra.*

100. David Llewellyn, *The Economic Rationale for Financial Regulation*, FIN. SERVS. AUTH. OCCASIONAL PAPERS IN FIN. REGUL., Apr. 1999, at 6.

unlike most goods or services, regulatory services are not supplied through a market process.[101] Regulatory services are not clearly bought and sold, making it difficult to identify the actual demand for such services. This can lead to serious allocation problems.[102] For example, information can be lost about the amount and type of regulation that various consumers of the regulation desire, the price the consumers are willing to pay for the regulation, and the changes in the usefulness or cost of the regulation that may occur over time.[103] Overall, the lack of a market process increases the likelihood that a suboptimal level of regulation is provided—with certain matters over-regulated while others are under-regulated. In a market-based setting, that allocation problem resolves itself through consumers expressing their demand for a service by purchasing (or not purchasing) it. Because regulations are less obviously bought and sold than traditional, commercial services, it is much more difficult to identify consumers' actual demand for the service. However, issuers' and investors' strong and persistent preference for the unregistered market strongly suggests they are <u>not buying</u> the registered market's regulatory services and, instead, are opting out.

II. RULE 506 AND THE ACCREDITED-INVESTOR DEFINITION

Congress has always recognized the need for exemptions to the registration process. When Congress created the registration requirement, it also inserted exemptions into the Securities Act. Securities Act section 3[104] exempts certain categories of securities from registration,[105] and Securities Act section 4[106] exempts certain transactions. One of the original transaction exemptions—commonly referred to as the "private placement exemption" and currently set forth

101. *Id.*
102. *Id.*
103. *Id.*
104. 15 U.S.C. § 77c.
105. Examples include securities issued or guaranteed by a U.S. or state government entity (Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2)), securities issued or guaranteed by a bank (Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2)), notes with a maturity of nine months or less (Securities Act § 3(a)(3), 15 U.S.C. § 77c(a)(3)), and securities issued by non-profit religious, educational, or charitable organizations (Securities Act § 3(a)(4), 15 U.S.C. § 77c(a)(4)).
106. 15 U.S.C. § 77d.

in Securities Act section 4(a)(2)[107]—exempts "transactions by an issuer not involving any public offering."[108] The private placement exemption established the principle that registration is not necessary for offerings to financially sophisticated investors who do not need "the protections afforded by registration."[109] Such sophisticated investors are allowed to opt out of the registration system since they can "fend for themselves."[110]

Section 4(a)(2)'s brevity—the entire statute consists of 21 words—has necessitated reams of interpretive cases that ultimately produce too much legal uncertainty for most transactions.[111] To provide that certainty, the SEC adopted Rule 506, which has since become the dominant regulatory path for exempt securities offerings.[112] Rule 506—which contains two exemptions, Rule 506(b) and Rule 506(c)—is a safe harbor for Section 4(a)(2). An offering by an issuer that complies with Rule 506(b) or Rule 506(c) "shall be deemed [a transaction] not involving any public offering within the meaning of section 4(a)(2) of the [Securities] Act."[113]

A. THE RULE 506(B) AND RULE 506(C) EXEMPTIONS

Rule 506(b), which is the original Rule 506 exemption, allows an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors and up to 35 nonaccredited investors who meet sophistication requirements.[114] Nonaccredited investors qualify as sophisticated if they, alone or with advisors, have "such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective

107. 15 U.S.C. § 77d(a)(2). The exemption was originally numbered section 4(1) when adopted in 1933 as part of the Securities Act. However, it was renumbered as section 4(2) in 1964 and as section 4(a)(2) in 2012, as part of the JOBS Act.

108. 15 U.S.C. § 77d(a)(2).

109. SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953).

110. *Id.* at 125 ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'").

111. *See* Andrew N. Vollmer, *Abandon the Concept of Accredited Investors in Private Securities Offerings*, 49 SEC. REG. L.J. 5, 9 (2021) [hereinafter Vollmer, *Abandon the Concept of Accredited Investors*].

112. *See infra* Table 4.

113. Regulation D Rule 506(a), 17 C.F.R. § 230.506(a) (2024).

114. Regulation D Rule 506(b)(2)(i)-(ii), 17 C.F.R. §§ 230.506(b)(2)(i)-(ii) (2024); Regulation D Rule 501(e), 17 C.F.R. § 230.501(e) (2024).

investment."[115] Rule 506(b) prohibits using general solicitations or advertising to market the offering.[116] When the issuer (or a person acting on its behalf) has a pre-existing, substantive relationship[117] with an offeree, making an offer is not a general solicitation.[118] To avoid violating the general solicitation prohibition, issuers frequently limit their Rule 506(b) offers to their existing contact network, or they engage brokers to serve as placement agents and thereby gain access to the brokers' contact networks.[119] Importantly, Rule 506(b) mandates the issuer furnish extensive disclosure to any nonaccredited investors who purchase securities in the offering.[120] If the issuer limits its Rule 506(b) sales only to accredited investors, there are no mandatory disclosure requirements.[121] However, if even a single nonaccredited investor makes a purchase, then Regulation D Rule 502(b)(1) applies:

> If the issuer sells securities under [Rule 506(b)] to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section 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.[122]

The explanatory note following the rule explains that when an issuer furnishes mandatory disclosure to any nonaccredited investors, "it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities

115. Regulation D Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (2024).

116. Regulation D Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2024); Regulation D Rule 502(c), 17 C.F.R. § 230.502(c) (2024).

117. A substantive relationship is one where the issuer (or a person acting on its behalf) has sufficient information to evaluate, and does evaluate, the offeree's financial circumstances and sophistication. SEC DIV. OF CORP. FIN., SEC STAFF COMPLIANCE & DISCLOSURE INTERPRETATIONS, SECURITIES ACT RULES (last updated Nov. 20, 2023) [hereinafter SEC C&DIs], https://www.sec.gov/corpfin/securities-act-rules (Answer to Question 256.31).

118. *Id.* (Answer to Question 256.26).

119. When an issuer hires a broker as a placement agent, the issuer effectively acquires the broker's pre-existing substantive relationships to solicit investors. *See, e.g.*, E.F. Hutton & Co., SEC No-Action Letter, 1985 WL 55680, at *1 (Dec. 3, 1985).

120. Regulation D Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2024); Regulation D Rule 502(b), 17 C.F.R. § 230.502(b) (2024).

121. Regulation D Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) (2024).

122. *Id.*

laws."[123] Because most issuers conducting a Rule 506(b) offering prefer avoiding the expense and burden of producing the mandatory disclosure, few Rule 506(b) deals include any nonaccredited-investor purchasers. As noted earlier, the SEC estimates that only 6% of Rule 506(b) offerings between 2009 and 2022 involved nonaccredited investors.[124] Stated bluntly, investors who do not qualify as accredited investors generally are not welcome.

In 2013, in response to a Congressional mandate in JOBS Act section 201(a)(1), the SEC adopted the Rule 506(c) exemption. Rule 506(c) allows an issuer to use general solicitations or general advertising to sell an unlimited dollar amount of securities to an unlimited number of accredited investors provided all the buyers are accredited investors and the issuer takes reasonable steps to verify that they are.[125] Because there are no nonaccredited-investor purchasers, Rule 502(b)'s mandatory disclosure requirements do not apply.[126]

In short, the Rule 506 exemptions allow issuers to raise an unlimited amount of money without any mandatory disclosure requirements so long as they limit themselves to accredited-investor purchasers. If the issuer has an extensive network of accredited investors from which it can raise the funds, it can use Rule 506(b). If it does not, Rule 506(c) allows the issuer to generally solicit the public to find such accredited investors.

B. WHO QUALIFIES AS AN ACCREDITED INVESTOR?

Regulation D Rule 501(a)[127] defines the term "accredited investor." The SEC's stated purpose in crafting the definition has been "to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary."[128]

Mechanically, Rule 501(a) lists 13 categories of legal entities and natural persons who qualify as accredited investors. There are few, if any, concerns about the types of legal entities qualifying as accredited

123. *Id.*
124. 2023 SEC STAFF REPORT, *supra* note 20, at 37.
125. Regulation D Rule 506(c)(1)-(2), 17 C.F.R. §§ 230.506(c)(1)-(2) (2024).
126. Regulation D Rule 506(c)(1), 17 C.F.R. § 230.506(c)(1) (2024).
127. 17 C.F.R. § 230.501(a) (2024).
128. Release No. 33-10824, *supra* note 13, at 64235 (internal citations omitted).

investors. They include banks,[129] registered broker-dealers,[130] investment advisers,[131] insurance companies,[132] and certain funds.[133] Additionally, non-profits, corporations, partnerships, and limited liability companies with total assets exceeding $5 million qualify as accredited investors if they were not formed for the specific purpose of acquiring the securities offered.[134] Senior company managers—specifically, the issuer's directors, executive officers, or general partners—are also accredited investors.[135]

Concerns about the accredited-investor definition tend to focus on non-management natural persons. Non-management natural persons have historically qualified as accredited investors by satisfying either a net-worth threshold or an income threshold.

> **Net-worth threshold.** Individuals with a net worth exceeding $1 million (excluding the value of the individual's primary residence), either alone or with their spouse or spousal equivalent, are accredited investors.[136]
>
> **Income threshold.** Individuals with net income exceeding $200,000 in each of the last two years, or joint income with a spouse or spousal equivalent exceeding $300,000 in each of those years, and who reasonably expect to reach the same income level in the coming year are accredited investors.[137]

An investor's wealth is meant to serve "as a proxy for financial sophistication."[138] Presumably, such persons have either shown financial acumen to achieve their current wealth position, or they have the financial resources to hire experts to assist them with their unregistered investment choices.[139] Wealth also indicates an ability to bear the risk of loss. The SEC estimates that 18.5% of U.S. households qualified as

129. Regulation D Rule 501(a)(1), 17 C.F.R. § 230.501(a)(1) (2024).
130. *Id.*
131. *Id.*
132. *Id.*
133. Regulation D Rule 501(a)(2), 17 C.F.R. § 230.501(a)(2) (2024).
134. Regulation D Rule 501(a)(3), 17 C.F.R. § 230.501(a)(3) (2024).
135. Regulation D Rule 501(a)(4), 17 C.F.R. § 230.501(a)(4) (2024).
136. Regulation D Rule 501(a)(5), 17 C.F.R. § 230.501(a)(5) (2024).
137. Regulation D Rule 501(a)(6), 17 C.F.R. § 230.501(a)(6) (2024).
138. Release No. 33-10824, *supra* note 13, at 64235.
139. Finke et al., *supra* note 38, at 2.

accredited investors in 2022 based on at least one of the wealth thresholds.[140]

The 2020 Amendments expanded the accredited-investor definition to include new categories of natural persons "that qualify as accredited investors irrespective of their wealth, on the basis that such investors have demonstrated the requisite ability to assess an investment opportunity."[141] One of the new 2020 categories is for individuals holding certain SEC-designated credentials[142]—currently a Series 7, Series 65, or Series 82 license with the Financial Industry Regulatory Authority (FINRA)[143]—and another is for "knowledgeable employees" of a private fund for investments in that fund.[144] It is unclear how many additional accredited investors have been added due to the 2020 Amendments, but it does not appear to be a big number.[145] In the final rule release for the 2020 Amendments, the SEC suggested the new categories do not substantially enlarge the pool of natural-person accredited investors because many of the newly eligible investors already qualified under the wealth thresholds.[146] Although the SEC did not provide precise estimates, its upper bound estimate was a 4% increase in the number of individuals who qualify as accredited investors, which represents a 0.2% increase of the total population that qualifies.[147]

III. PRIVATE SOLUTIONS TO MARKET PROBLEMS

Because this article proposes allowing more individuals to participate in the high-risk, lightly regulated Rule 506 market, it is important to appreciate that government regulations are not the sole solution for reducing market problems and making investors safer. Economic theory posits that unhindered markets where private actors are left to compete are the most efficient structure, with competition

140. 2023 SEC Staff Report, *supra* note 20, at 23.
141. Release No. 33-10824, *supra* note 13, at 64235.
142. Regulation D Rule 501(a)(10), 17 C.F.R. § 230.501(a)(10) (2024).
143. Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status, Securities Act Release No. 33-10823, 85 Fed. Reg. 64234, 64234 (Aug. 26, 2020).
144. Regulation D Rule 501(a)(11), 17 C.F.R. § 230.501(a)(11) (2024).
145. 2023 SEC Staff Report, *supra* note 20, at 29-30.
146. Release No. 33-10824, *supra* note 13, at 64262.
147. *Id.*

between self-interested buyers and sellers generating the best results. However, as discussed earlier, securities markets demonstrate systematic problems—most notably, information asymmetries between the issuer and investors—that reduce their efficiency. Solutions to such market problems are needed if the U.S. securities markets are to operate efficiently and provide a reasonably safe environment for investors. Requiring registration or limiting who can invest in certain markets are government solutions to market problems, but private solutions can be just as important.

The vibrancy and success of a securities market depends on a mix of both public and private solutions to market problems. As Edmund Kitch explains,

> In any jurisdiction, the law governing the issuance of and trading in securities is a mix of public laws and regulations, requirements of private industry organizations, industry custom and private contractual arrangements. The portion that is generated privately in the form, for instance, of industry agreements, customs and practices, is often difficult for scholars to access. The portion that is generated publicly will be more easily accessible in the form of published laws, regulations and regulatory and judicial decisions, and thus is more likely to be made the subject of academic description and analysis. In all jurisdictions the public portion will, like the part of an iceberg that is above the water, tell only a part of the story.[148]

Federal and state laws and regulations have played an important role in making the U.S. securities markets some of the most efficient and successful markets in the world, but it is only a partial role. Private solutions have also been critical to that success. For example, numerous private intermediaries—such as accelerators,[149] angel groups, investment

148. Edmund W. Kitch, *Regulation of the Securities Market*, in ENCYCLOPEDIA OF LAW AND ECONOMICS 813, 815 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), https://reference.findlaw.com/lawandeconomics/contents.html.

149. Accelerators are highly selective programs that help speed up the business development process for young startups. Accelerators bring in cohorts of startups for an intense, immersive experience. Most programs have a fixed term (such as three months) during which time the startups work with a group of mentors to jumpstart their businesses. *See* Susan G. Cohen & Yael V. Hochberg, *Accelerating Startups: The Seed Accelerator Phenomenon* 9-12 (Rsch. Pol'y, Working Paper, 2014), https://ssrn.com/abstract=2418000; C. Scott Dempwolf et al., *Innovation Accelerators: Defining Characteristics Among Startup Assistance Programs*, U.S. SMALL BUS.

banks, mutual funds, proxy services, research analysts, and venture capital firms—have formed to provide information gathering and assessment services, monitoring services, and other beneficial services to investors.[150] Industry customs and private contractual agreements have also developed to address the unique challenges presented by different securities markets.

Venture capital firms provide an instructive example of how private solutions can solve challenging securities market problems. These firms serve as financial intermediaries for accredited investors who want to invest in unregistered securities offerings for high-growth startups but are uncomfortable making those investments directly due to information asymmetries and other concerns such as agency problems[151] (including the need to monitor management) and the extreme uncertainty that comes from investing in unproven startups that often involve new technologies.[152] These uncomfortable accredited investors can indirectly invest in startups by investing in a venture capital firm that expertly invests those dollars on their behalf. Venture capital firms have developed various customs, practices, and private contractual protections to reduce the information, agency, and uncertainty problems that affect startups, thus allowing venture capitalists to thrive in an otherwise challenging investment environment. Venture capital customs and practices include employing substantial pre-investment screening processes, staging investments, syndicating investments, and demanding seats on the issuer's board of directors.[153] Private contractual protections include using sophisticated financial instruments—namely, highly customized convertible preferred stock or deferred equity instruments,

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ADMIN., OFF. OF ADVOC. 3-5 (Oct. 2014), https://advocacy.sba.gov/2014/10/01/innovation-accelerators-defining-characteristics-among-startup-assistance-organization.

150. *See generally* JOSH LERNER & ANN LEAMON, VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP (2d ed. 2024); JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Orcutt, *Improving the Efficiency of the Angel Finance Market*, *supra* note 42; Choi, *Framework for Regulation*, *supra* note 45; Choi & Fisch, *supra* note 43; PAUL A. GOMPERS & JOSH LERNER, THE MONEY OF INVENTION: HOW VENTURE CAPITAL CREATES NEW WEALTH (2001).

151. *See* Orcutt, *Improving the Efficiency of the Angel Finance Market*, *supra* note 42, at 883-84 (discussing the related agency problems for the angel market).

152. *See* John Orcutt, *Valuing Young Startups is Unavoidably Difficult: Using (and Misusing) Deferred-Equity Instruments for Seed Investing*, 55 TULSA L. REV. 469, 477-99 (2020) [hereinafter Orcutt, *Valuing Young Startups*].

153. *See generally* SMITH & SMITH, *supra* note 41, at 94-113.

such as convertible notes[154] or the simple agreement for future equity ("safes")[155]—and requiring the issuer to agree to terms that better align the interests of the issuer and its founders/managers with those of the venture capital firm.

Angel groups are another private-solution example. Angels are wealthy individuals who invest their own capital directly in startups.[156] In the 1990s, many angels began to create formalized groups (or "angel syndicates"[157]) to improve their investing experience.[158] Angel groups have since become common place and now even have a professional association, Angel Capital Association, that supports more than 250 angel groups and platforms.[159] How angel groups function varies considerably, but common benefits from investing through a group include:

154. *See id.* Professional startup investors began using convertible notes in earnest to invest in startups around 2005. John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 136 (2014). *See also* Orcutt, *Valuing Young Startups*, *supra* note 152, at 478 ("Convertible notes are short-term loans that convert to equity if the startup completes a qualified future equity financing. They are debt instruments, meaning the startup must repay the principal and pay interest. However, unlike traditional debt, convertible note investors do not look to be repaid with cash. Instead, they hope to be repaid with shares from the qualified future equity financing.").

155. The first safe was invented by Carolyn Levy, a Y Combinator partner, in 2013. Paul Graham, *Announcing the Safe, a Replacement for Convertible Notes*, Y COMBINATOR (Dec. 6, 2013), https://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes/. Safes "are a contractual right to receive a startup's stock if it completes a qualified future equity financing. Unlike convertible notes, safes do not require repayment. Investors purchase the safes and receive stock in the qualified future equity financing if it occurs." Orcutt, *Valuing Young Startups*, supra note 152, at 478.

156. Orcutt, *Improving the Efficiency of the Angel Finance Market*, *supra* note 42, at 876.

157. MARK VAN OSNABRUGGE & ROBERT J. ROBINSON, ANGEL INVESTING: MATCHING START-UP FUNDS WITH START-UP COMPANIES 43-46 (2000).

158. Band of Angels, for example, formed in 1994. Still operating today, Band of Angels touts itself as "the first high-tech angel investment group in the USA." *Investing In and Mentoring Silicon Valley's Best Seed Stage Startups Since 1994*, BAND OF ANGELS, https://www.bandangels.com/ (last visited Jan. 16, 2025).

159. *Mission and Leadership*, ANGEL CAPITAL ASSOCIATION, https://angelcapitalassociation.org/mission-and-leadership/ (last visited Jan. 16, 2025).

- More deal flow;
- More opportunities to diversify investments in the Rule 506 market;
- Improved due diligence;
- Better ability to monitor and mentor the issuers' managers;
- Better ability to learn of and adopt best-practice investment procedures and terms;
- Better ability to make larger investments that provide access to more opportunities and at better terms;
- Providing a collectivizing mechanism to pay for legal counsel and other investment-related expenses; and
- Sometimes one of the group members may serve as an outside director on an issuer's board.[160]

Private solutions can also fill in when a regulatory solution retreats from a potential problem. When issuers conduct Rule 506 offerings that include only accredited-investor purchasers, Rule 506 does not mandate any specified disclosure requirements. Even though not legally required, issuers have shown that they will furnish investors with meaningful disclosure. During late 2019 and early 2020, Andrew Vollmer conducted a survey of practitioners who represented clients in thousands of unregistered securities transactions in which accredited investors were the only buyers.[161] Vollmer's survey found:

> [T]he deals 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

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160. *See generally* Josh Lerner & Antoinette Schoar, *Rise of the Angel Investor: A Challenge to Public Policy*, THIRD WAY (Sept. 23, 2016), https://www.thirdway.org/report/rise-of-the-angel-investor-a-challenge-to-public-policy; Alejandro Cremades, *How Angel Investors and Angel Groups Work*, FORBES (updated Dec. 10, 2021), https://www.forbes.com/sites/alejandrocremades/2018/09/25/how-angel-investors-and-angel-groups-work/.

161. Andrew N. Vollmer, *Evidence on the Use of Disclosure Documents in Private Securities Offerings to Accredited Investors*, 4-5 (Geo. Mason. U. Mercatus Working Paper, 2020), https://www.mercatus.org/research/working-papers/evidence-use-disclosure-documents-private-securities-offerings-accredited-0.

> 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 disclosure. 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.[162]

Limiting Rule 506 offerings to accredited investors, therefore, does not eliminate actual disclosure. Instead, limiting the transaction to accredited investors simply provides the issuer and its investors with flexibility to determine what level of disclosure is appropriate for the offering.[163] Rather than subject themselves to a one-size-fits-all minimum disclosure requirement that may not be relevant for a particular deal, or cost ineffective to produce, issuers and investors can fashion a private solution and make their own disclosure decisions.

This discussion of private solutions to market problems is important because, as Kitch noted, it is easy to focus on government solutions to market problems and forget about possible private solutions. Many will likely worry that reducing government regulation of the Rule 506 market by expanding the population who can invest will lead to inordinate risk and fraud for currently nonaccredited investors. However, it is important to remember that reducing government regulation does not mean that nonaccredited investors who are converted to accredited status are left unprotected. The Rule 506 market has spent decades developing private solutions to address its problems. One reason for the consistent and sustained success of the United States' entrepreneurial startup sector has been the ability of the country's startups to access capital through unregistered securities markets. And those unregistered securities markets have flourished and grown in part due to investors developing private solutions to the startup sector's securities market problems. Venture capital firms, angel investors, accelerators, and other accredited investors all opted out of the registered market's protections and developed their own protections that

162. *Id.* at 20-21.

163. Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 13.

are more explicitly suited to the startup sector's specific market problems.

IV. CONCERNS ABOUT THE CURRENT ACCREDITED-INVESTOR DEFINITION FOR NATURAL PERSONS

No one would credibly suggest that venture capital firms, serious angel investors, or accelerators should not be allowed to opt out of the registered market's protections. However, this raises the question: who else should be allowed to opt out? The accredited-investor definition is the dividing line for who can opt out. Some suggest the definition for natural persons is over-inclusive and allows individuals who should not be investing in the Rule 506 market to invest. Others suggest the definition is under-inclusive and improperly excludes too many individuals.

A. THE DEFINITION MAY BE OVER-INCLUSIVE

1. Inflation

One of the loudest calls for change to the accredited-investor definition for natural persons is to adjust the wealth thresholds to account for inflation.[164] While the SEC has amended the accredited-investor definition four times since its 1982 adoption,[165] it has not increased the income thresholds or adjusted them for inflation. In 2011, the SEC increased the net worth threshold; Section 413(a) of the Dodd-Frank Act requires that the value of an individual's primary residence be

164. *See, e.g.*, SEC, STAFF REPORT: REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 89-91 (Dec. 18, 2015) [hereinafter 2015 SEC STAFF REPORT]; Letter from North American Securities Administrators Association ("NASAA") to Erik F. Gerding, Dir., Div. of Corp. Fin., SEC 5 (Mar. 7, 2023) [hereinafter 2023 NASAA Letter to Dir. Gerding], https://www.nasaa.org/comment-letters/nasaa-comment-letter-to-the-sec-regarding-private-market-reforms/2023-03-07-letter-to-erik-gerding-regarding-private-market-reforms/; Comm'r Lee Accredited Investor Statement, *supra* note 19.

165. 2023 SEC STAFF REPORT, *supra* note 20, at 14. The SEC amended the definition in 1988, 1989, 2011, and 2020. Regulation D Revisions, Securities Act Release No. 33-6758, 53 Fed. Reg. 7866, 7866 (Mar. 3, 1988); Regulation D; Accredited Investor and Filing Requirements, Securities Act Release No. 33-6825, 54 Fed. Reg. 11369, 11369 (Mar. 14, 1989); Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, 76 Fed. Reg. 81793, 81793 (Dec. 21, 2011); Release No. 33-10824, *supra* note 13, at 64234.

excluded when determining the individual's net worth, which the SEC implemented in 2011 by amending the accredited-investor net worth definition.[166] Other than the 2011 amendment, however, the SEC has not increased the $1 million threshold, and it is not indexed to inflation.

Four decades after the regulation's initial adoption, the wealth thresholds no longer have the same meaning they once did. The $1 million net worth threshold and the $200,000 individual income threshold were established in April 1982,[167] while the $300,000 joint income threshold was established in April 1988.[168] Table 2 shows the inflationary effect on those thresholds using the Consumer Price Index (CPI).[169]

Table 2: Inflationary Effect on the Wealth Thresholds Using CPI[170]

	Date Adopted	**Value at Adoption**	**Value at December 2024**
Net worth threshold	April 1982	$1 million	$3.3 million
Individual income threshold	April 1982	$200,000	$665,132
Joint income threshold	April 1988	$300,000	$808,553

Largely due to inflation, the SEC estimates (based on the CPI) that the number of U.S. households that qualify as accredited investors under the wealth thresholds has grown from 1.8% in 1983 to 18.5% in 2022.[171] If the wealth thresholds remain unchanged, the SEC estimates (based on the CPI) that 31.4% of households would qualify as accredited investors

166. Release No. 33-9287, *supra* note 165, at 81793.

167. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251, 11255 (Mar. 8, 1982).

168. Release No. 33-6758, *supra* note 165, at 7867.

169. *Infra* Table 2.

170. Based on an application of the average Consumer Price Index (CPI) from April 1982 or April 1988 through December 2024. *CPI Inflation Calculator*, U.S. BUREAU OF LAB. STATS., https://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 16, 2025).

171. 2023 SEC STAFF REPORT, *supra* note 20, at 23-24.

by 2032, 49.2% would qualify by 2042, and 65.9% would qualify by 2052.[172]

Some commentators—including the North American Securities Administrators Association (NASAA),[173] which often serves as a voice for state securities regulators, charge that Regulation D's failure to adjust the wealth thresholds for inflation has caused the current thresholds to become over-inclusive and capture financially unsophisticated individuals who are not able to fend for themselves or bear the risk of loss.[174] Some suggest adjusting the current wealth thresholds to account for past inflation and then indexing them to inflation going forward.[175] At least one commentator has suggested maintaining the current thresholds but indexing them to inflation going forward.[176]

Adjusting the wealth thresholds has intuitive appeal. If the original numbers provided a relatively accurate approximation of which individuals were financially sophisticated and able to bear losses, it is hard to imagine those numbers are still correct today. However, this line of reasoning relies on a critical assumption. It assumes the original numbers accurately approximated financial sophistication and loss tolerance, but that does not appear to have been the case. A review of Regulation D's proposing[177] and adopting[178] releases show the wealth thresholds were nothing more than a good faith guess by the SEC on where to draw the line between sophisticated and unsophisticated. In the proposing release, the SEC made the following proposal for the wealth thresholds:

> (c) any natural person whose individual net worth is in excess of $750,000; and, (d) any natural person whose most recent individual annual adjusted gross income exceeded $100,000 as reported for federal income tax

172. *Id.* at 26-28.

173. 2023 NASAA Letter to Dir. Gerding, *supra* note 164, at 5.

174. *See* 2023 SEC STAFF REPORT, *supra* note 20, at 47.

175. *See, e.g.*, 2023 NASAA Letter to Dir. Gerding, *supra* note 164, at 5.

176. *See, e.g.*, Letter from SEC Small Business Capital Formation Advisory Committee to Jay Clayton, Chair, SEC (Dec. 11, 2019) [hereinafter SEC Small Business Capital Formation Letter], https://www.sec.gov/spotlight/sbcfac/recommendation-accredited-investor.pdf.

177. Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6339, 46 Fed. Reg. 41791 (Aug. 7, 1981).

178. Release No. 33-6389, *supra* note 167.

> purposes in his most recent tax return (individual not joint income).[179]

The SEC's only explanation for its proposed thresholds was:

> The [wealth threshold] proposals address the concerns of many commentators who believed the Commission should develop an objective test for individuals . . . . These commentators criticized the current definition of accredited investor as excluding many persons with financial experience and sophistication . . . . These new categories which have been added in response to those concerns are consistent with similar types of exemptions followed under several state securities laws and have been developed in consultation with NASAA.[180]

In response to comments received, the SEC ultimately adopted increased thresholds of $1 million and $200,000 with almost no explanation as to how those numbers were reached.[181] Regarding the net-worth test, the SEC stated:

> The Commission proposed a level of $750,000 for this test. Some commentators, however, recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to $1,000,000 without exclusions.[182]

Regarding the income test, the SEC, without explanation, expanded the income period from the most recent year to the two most recent years plus a reasonable expectation for the current year.[183] The SEC also discarded "adjusted gross income"—a number reported on the federal income tax return—as the means for calculating annual income due to commentator concerns about tax filing and calculation issues.[184] In place of adjusted gross income, the SEC adopted a more general approach for calculating gross income, which was the sole explanation given for increasing the income threshold to $200,000.[185]

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179. Release No. 33-6339, *supra* note 179, at 41796.
180. *Id.*
181. Release No. 33-6389, *supra* note 167, at 11255.
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.*

> Also, the term "adjusted gross income" has been changed to "income". Use of the term "income" will permit the inclusion of certain deductions and additional items of income which, as noted above, were excluded in the proposed concept of adjusted gross income. Accordingly, the appropriate income level has been raised to $200,000.[186]

Another way to view the original wealth thresholds would be to think of them as a trial-and-error experiment. The initial thresholds may have been guesses, but not indexing the thresholds to inflation has allowed the agency to run a gradual, four-decade experiment on where to draw the line. Each year, inflation erodes the original thresholds slightly and the pool of accredited investors slowly grows. If substantial investor-protection problems do not arise during that year, a slightly lower dividing line is shown to be okay, and the experiment continues for the next year. The 2008-09 financial crisis was an example when Congress appears to have found substantial investor-protection problems related to the net-worth threshold. Congress apparently felt the dividing line was too low, so it responded with section 413(a) of the Dodd-Frank Act, and the SEC excluded primary residences from the net worth calculation in 2011.

Do the wealth thresholds need to be adjusted? Absent substantial investor-protection problems, they probably do not need to be adjusted upwards and could even be adjusted downwards. If the SEC is seeing significant fraud or financial distress among investors that are just over the thresholds, then raising the thresholds would be an appropriate response. Without a data-driven analysis (such as an increase in investor-protection problems), any adjustment to the wealth thresholds is just another guess, and the commencement of a new trial-and-error experiment. Trial-and-error experiments are a highly effective decision-making tool, but they also introduce uncertainty and risk. In the final rule release for the 2020 Amendments, the SEC explained that it considered increasing the wealth thresholds to account for inflation since their implementation.[187] Such a move would have greatly reduced the number of natural persons who would qualify as accredited investors from an estimated 13% of the population of U.S. households (in 2020) to just over 4%.[188] One reason the SEC decided not to make the upward

186. *Id.*
187. Release No. 33-10824, *supra* note 13, at 64273.
188. *Id.*

adjustments is that such a change could involve "potentially significant costs. In particular, adjusting the income and wealth thresholds may reduce private issuers' access to capital and would reduce investors' access to private investment opportunities."[189]

This article's proposal helps to reduce these types of "cost" concerns by reducing the stakes for the SEC's decision. If the SEC gets concerned—even without definitive data—that individuals with annual incomes up to $300,000 are showing lower sophistication levels or greater distress from loss, it could raise the threshold and target that group with a strong investor-education campaign. Since individual investors would retain the ability to opt out of being labeled nonaccredited, those investors who are more capable of operating in the Rule 506 market could continue to have access to private investment opportunities and fund private issuers. The more vulnerable investors could be discouraged, while the more sophisticated investors could continue to participate in the market.

2. Retirement Assets

A related over-inclusion concern derives from the assets used for the net-worth calculation. Some have called for individuals' retirement assets to be excluded from the net-worth calculation.[190]

Individuals can hold retirement assets in employer-sponsored plans or in Individual Retirement Accounts (IRAs).[191] There are two types of employer-sponsored plans: defined benefit plans and defined contribution plans.[192] With a defined benefit plan, the employer takes all the investment risk and guarantees all pension recipients a fixed or determinable benefit.[193] "As long as the plan and the employer(s) contributing to the plan remain solvent, and the plan continues to be

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189. *Id.*

190. *See, e.g.*, 2023 NASAA Letter to Dir. Gerding, *supra* note 164, at 4; Letter from Da Kui to Vanessa A. Countryman, Sec'y, SEC, 5-6 (Jan. 10, 2020) [hereinafter Da Kui Letter], https://www.sec.gov/comments/s7-25-19/s72519-6634586-203223.pdf; Larissa Lee, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 UTAH L. REV. 369, 386-87 (2014).

191. *See* JOHN J. TOPOLESKI ET AL., CONG. RSCH. SERV., R47699, U.S. RETIREMENT ASSETS: DATA IN BRIEF (2023) ("Summary" section).

192. Employee Benefit Plans, Securities Act Release No. 33-6188, 45 Fed. Reg. 8960, 8963 (Feb. 1, 1980).

193. *See id.*

operated, vested participants will receive the benefits specified."[194] Defined contribution plans, such as 401(k)s (named for the IRS Tax Code section governing it), do not pay fixed benefits.[195] The investment risk resides with the retiree in a defined contribution plan as payouts depend on the participant's contributions and the success of the plan's investments.[196]

When the SEC established the net-worth threshold, Americans stored their retirement wealth differently than today. For example, in 1982, private sector employees were more likely to participate in a defined benefit plan (where the employer bears the investment risk) than a defined contribution plan (where the retiree bears the risk). "[I]n 1982[,] private sector defined benefit plans had 29.7 million active participants, while private sector defined contribution plans had 23.4 million active participants."[197] In 2020, private sector defined benefit plans had 12 million active participants compared to 85.3 million active participants in defined contribution plans.[198]

Individuals now bear more investment risk for their retirement assets held through employer-sponsored plans. At the same time, they also bear more investment risk due to a dramatic increase in retirement assets held through IRAs. IRAs accounted for 2.5% of retirement savings in 1980 compared to 34% as of December 31, 2022.[199]

> A significant amount of the value of assets within IRAs is money that has been rolled over from prior employer sponsored defined contribution plans. This appears to be driven by the fact that when individuals leave their jobs they often want to have greater control over their investment decisions by rolling the funds into an IRA rather than leaving the funds in plans controlled by their prior employers.[200]

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194. *Id.* ("In the event the investment results of the plan do not meet expectations, the employer(s) usually will be required, on the basis of actuarial computations, to make additional contributions to fund the promised benefits. Conversely, if plan earnings are better than anticipated, the employer(s) may be permitted to make contributions that are less than the projected amounts.").

195. *Id.*

196. *Id.*

197. 2023 SEC STAFF REPORT, *supra* note 20, at 30-31.

198. *Id.* at 31.

199. *Id.* at 32.

200. *Id.*

Shifting funds from defined contribution plans to IRAs may increase investment risk because investment decisions are "shifted away from a professional custodian with a fiduciary duty, as is the case with employer sponsored plans, to the individual investor, who may lack experience in building a portfolio that appropriately allocates risk and ongoing management of investments, including preparing for the illiquid nature of private company investments."[201]

The justification for excluding retirement assets from the net-worth calculation can be summarized roughly as follows:

- An individual's retirement assets may account for a significant portion of that person's net worth.[202]
- For elderly individuals who are retired, or close thereto, this presents heightened concerns. Such elderly individuals "may have a lower risk tolerance than the general population and less ability to bear the burden of potential losses."[203] Moreover, individuals who reach advanced age levels (e.g., 80 years old) may experience cognitive decline that erodes their ability to evaluate complex investments.[204]
- Retirement assets "should be considered essential components of a person's financial well-being,"[205] like a primary residence, and should not be risked by investing in the Rule 506 market.

Making very speculative investments that place a significant portion of one's retirement savings at risk—particularly as one gets older—is a bad idea. In fact, it is a very bad idea. The proposals to exclude retirement assets from the net-worth calculation presume that all (or at least most) individuals fail to appreciate this obvious cautionary point. Accumulating a significant amount of retirement assets shows the individual has some financial discipline and common sense. Rather than

201. *Id.* at 32-33.
202. Letter from NASAA to Vanessa Countryman, Sec'y, SEC 6 (Mar. 16, 2020) [hereinafter 2020 NASAA Letter to Sec'y Countryman], https://www.sec.gov/comments/s7-25-19/s72519-6960323-212740.pdf.
203. 2023 SEC STAFF REPORT, *supra* note 20, at 33.
204. Finke et al., *supra* note 38, at 1, 8.
205. 2020 NASAA Letter to Sec'y Countryman, *supra* note 204, at 6.

spend surplus dollars on current pleasures, the individual had the foresight to invest in the future. At the same time, it is possible that as individuals reach advanced age levels, cognitive decline and other similar factors may make them particularly vulnerable to fraud and financial abuse.

Protecting the elderly from financial abuse should be a primary focus for the SEC. However, preventing a 40-year-old from including the value of her 401(k) in her net-worth calculation does little to help the elderly. Additionally, coming up with rules that paint all individuals of advanced age as needing special protection is offensive. As the SEC considers solutions to combat financial elder abuse in the Rule 506 market, this article's proposal provides some assistance because, as explained above, it softens the SEC's decision by allowing individuals to decide for themselves if they should be treated as accredited. If the SEC decides to implement measures to protect the elderly and goes too far, the opt-out provides an override feature that allows individuals to say "no thank you" for the extra protection. If the SEC becomes concerned that the elderly are opting out in a hazardous manner, or that issuers (or their agents) are engaging in predatory practices to convince the elderly to agree to opt-outs, that problem can be dealt with in a tailored manner by placing more safeguards on the opt-out process for individuals of an advanced age.

B. THE DEFINITION MAY BE UNDER-INCLUSIVE

While some argue the definition includes too many people, others argue it does not include enough.

1. Rule 506 Market's Growth

The Rule 506 market has grown to become the United States' largest capital-raising market. From 2009 through 2022, almost 250,000 issuers collectively raised $19.8 trillion of capital through Rule 506.[206] The SEC adopted Regulation D, including the original Rule 506 exemption, in 1982[207] "in response to the Small Business Investment Incentive Act of 1980, which was intended to address difficulties small businesses had experienced raising capital amid the challenging

206. 2023 SEC STAFF REPORT, *supra* note 20, at 41.
207. *See* Release No. 33-6389, *supra* note 167, at 11251.

economic conditions of the 1970s."[208] Rule 506 was envisioned as a tool for small, pre-IPO startups to raise capital.[209] Startups are the beating heart of the United States' entrepreneurial economy. They "create new products, markets, processes for doing business, and even new industries" to compete with established competitors and, in doing so, they constantly revolutionize and renew the U.S. economy.[210] To perform that function, however, startups need capital to launch and grow. Rule 506 provides them with a more certain regulatory pathway for raising capital via unregistered securities offerings. The original vision for Rule 506 continues today, as offerings by small startups still account for more than half the Rule 506 offerings.[211] However, additional issuers have also flocked to the Rule 506 market,[212] and most of the capital raised under Rule 506 is now for pooled investment funds.[213]

Table 3: Summary Statistics for Rule 506 Offerings from Jan. 1, 2009 to Dec., 31, 2022[214]

	Non-Fund Issuers	Pooled Investment Funds
Number of issuers	136,879	111,033
Amount reported sold	$2.7 trillion	$17.1 trillion
Mean amount sold (if reported)	$12.1 million	$61.2 million
Median amount sold (if reported)	$1.3 million	$3.0 million

Rule 506 offerings accounted for 50.9% of the capital raised in U.S. offerings for the two-year period from July 1, 2022 to June 30, 2024 and

208. 2023 SEC STAFF REPORT, *supra* note 20, at 38-39.
209. *See* Release No. 33-6389, *supra* note 167, at 11251.
210. *See* Orcutt, *Improving the Efficiency of the Angel Finance Market*, *supra* note 42, at 861.
211. 2023 SEC STAFF REPORT, *supra* note 20, at 39.
212. *Id.*
213. *See infra* Table 3.
214. 2023 SEC STAFF REPORT, *supra* note 20, at 41.

44.1% of the capital raised for the five-year period from July 1, 2019 to June 30, 2024.[215]

Table 4: Regulatory Pathways Used to Raise Capital in the United States for the 12-Months Ended June 30, 2020 – 2024[216]

Exempt offerings	2020	2021	2022	2023	2024
Rule 506(b)	$1.4 trillion	$1.9 trillion	$2.3 trillion	$2.7 trillion	$1.9 trillion
Rule 506(c)	$69 billion	$124 billion	$148 billion	$169 billion	$137 billion
Rule 504	$171 million	$313 million	$624 million	$258 million	$246 million
Regulation A	$1.3 billion	$1.7 billion	$1.8 billion	$1.5 billion	$1.5 billion
Regulation Crowdfunding	$88 million	$174 million	$368 million	$352 million	$249 million
Other exempt offerings	$1.2 trillion	$1.3 trillion	$2.0 trillion	$1.3 trillion	$1.0 trillion
Total Rule 506 offerings	$1.5 trillion	$2.0 trillion	$2.5 trillion	$2.9 trillion	$2.0 trillion
Total exempt offerings	**$2.7 trillion**	**$3.3 trillion**	**$4.5 trillion**	**$4.2 trillion**	**$3.1 trillion**

Registered offerings	2020	2021	2022	2023	2024
Initial public offerings	$60 billion	$317 billion	$126 billion	$17 billion	$32 billion
Other registered offerings	$1.5 trillion	$1.4 trillion	$1.1 trillion	$1.1 trillion	$1.2 trillion
Total registered offerings	**$1.6 trillion**	**$1.7 trillion**	**$1.2 trillion**	**$1.1 trillion**	**$1.2 trillion**

215. *See infra* Table 4; 2024 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14-15; 2023 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14; 2022 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 13; 2021 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 11; 2020 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 11.

216. 2024 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14-15; 2023 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 3, at 14; 2022 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 13; 2021 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 11; 2020 SMALL BUSINESS CAPITAL FORMATION REPORT, *supra* note 73, at 11.

The Rule 506 market's increased importance does not appear to be some type of short-term, reactionary trend but instead appears to be a systemic change in the way issuers raise capital. A lot of the high-growth companies that once used IPOs to fund much of their growth now employ other strategies. Many decide to remain private longer and use the Rule 506 market to fund a much larger portion of their growth phase.[217] Others use the Rule 506 market to fund their early growth then pursue M&A strategies and sell themselves to large strategic buyers when they need substantial capital.[218] The combination of issuers remaining private longer and M&A exit strategies "limits the ability of the bulk of retail investors to invest in startups during their high-growth phase."[219] Since more than 80% of Americans are nonaccredited investors, most are legally deprived of the opportunity to "capture the returns generated by that surge in growth,"[220] which is only made available to a small group of natural persons.[221]

Regulations—not markets and individual choices—are dictating the investment opportunity. Part V.E considers the possibility that Rule 506 issuers may not be interested in accepting investors who, due to their reduced income and net worth, can only make relatively small investments. That possibility is real, and all the fuss about under-inclusion and the need to expand the accredited investor population could end up being much ado about nothing. However, such an outcome would be the result of free-market choices, which is how the U.S. economy is supposed to work, rather than the SEC "[s]orting investors into the favored and disfavored classes."[222]

217. *See* Michael Ewens & Joan Farre-Mensa, *Private or Public Equity? The Evolving Entrepreneurial Finance Landscape*, 14 ANN. REV. FINANC. ECON. 271, 286-87 (2022) ("[M]any of the private firms now raising late-stage rounds, would probably have already gone public and would thus be raising public capital three decades ago.").

218. *See NVCA 2024 Yearbook*, NATIONAL VENTURE CAPITAL ASSOCIATION 32-35 (2024), https://nvca.org/wp-content/uploads/2024/05/2024-NVCA-Yearbook.pdf.

219. Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 15.

220. Knight, *supra* note 69, at 14.

221. *See* MNUCHIN & PHILLIPS, *supra* note 21, at 27.

222. Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 15.

2. Clumsy Proxies for Financial Sophistication

The wealth thresholds are the original accredited-investor definitions for natural persons, and few would argue that they are anything other than a "clumsy proxy for [financial] sophistication."[223] Bright-line rules like the wealth thresholds are easy to administer and provide beneficial clarity, but they are also "necessarily under- and over-inclusive."[224] Individuals may obtain substantial net worths or high incomes without having any connection to the world of securities investing, while other individuals may be quite competent at considering and valuing securities investments without having achieved the wealth thresholds.[225] For example, an individual who achieved a high net worth from an inheritance and has no business or securities-investing experience, is unlikely to be financially sophisticated, while a personal finance professional who is below the wealth thresholds may be very sophisticated.[226]

The 2020 Amendments sought to reduce the wealth thresholds' under-inclusion problem by providing a path for investors to demonstrate their financial sophistication. The 2020 Amendments are a step in the right direction. Licensed financial professionals should be allowed to participate in the Rule 506 market, and so too should knowledgeable employees of a private fund for investments in that fund. However, the 2020 Amendments were only a small step that was largely limited to a narrow band of individuals who work in the finance sector. As noted above, the 2020 Amendments only marginally increase the pool of accredited investors.

In 2023, the U.S. House of Representatives sought to take a much larger step. On May 31, 2023, the House voted 383 to 18 to pass H.R.

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223. Comm'r Lee Accredited Investor Statement, *supra* note 19; *see, e.g.*, Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 20; 2015 SEC STAFF REPORT, *supra* note 164, at 89. *See generally, e.g.*, Release No. 33-10824, *supra* note 13, at 64236; Amending the "Accredited Investor" Definition, Securities Act Release No. 33-10734, 85 Fed. Reg. 2574, 2582 (Dec. 18, 2019).

224. 2015 SEC STAFF REPORT, *supra* note 164, at 89.

225. *See* Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 20-21.

226. *See* 2015 SEC STAFF REPORT, *supra* note 164, at 89.

2797,[227] the Equal Opportunity for All Investors Act of 2023,[228] which would amend the accredited-investor definition to include natural persons who have passed a certifying exam that that the SEC would develop.[229] The bill, which remains stalled in the Senate, seeks to create a pathway for more financially sophisticated individuals who are not wealthy to become accredited investors.[230] The certifying-exam idea has intuitive appeal; give everyone a chance to prove their sophistication. However, it is worth noting that the certifying exam would be an outlier regulatory approach. Requiring individuals to prove their sophistication through a government-sponsored certification exam before they can invest effectively serves as a licensing solution.[231] Like a pilot must obtain a government pilot's license before being allowed to fly,[232] investors would prove their sophistication (obtain a license) before being allowed to invest in the inherently risky Rule 506 market. Comparing investing (a risky activity) to flying (another risky activity) makes for an easy-to-convey analogy, but it may also be a misplaced analogy. The government does not require individuals to obtain licenses to protect the licensees from themselves when performing a risky activity. The government typically requires individuals to obtain licenses to protect society from externalities the licensees may generate. A driver must obtain a government-issued license to operate a motor vehicle due to the danger that an incompetent driver poses to others on the public roads. A doctor must obtain a government-issued license to practice medicine due to the danger that an incompetent healthcare professional poses to the public.[233] A recreational fisherperson must

227. Equal Opportunity for All Investors Act of 2023, H.R. 2797, 118th Cong. (2023); 169 Cong. Rec. H2706 (daily ed. May 31, 2023) (record of roll call vote on passage of H.R. 2797)

228. H.R. 2797, 118th Cong. § 1 (2023).

229. *Id.* § 2.

230. *See* H.R. Rep. No. 118-77, at 2 (2023).

231. *See generally* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 283, 310-19 (2000). Choi proposed that the government license investors before allowing them "to deal with particular types of capital market participants." *Id.* at 283.

232. *Id.* at 283.

233. *See* Gabe Scheffler, *Is the U.S. "Over-Licensed?" The Case for Reforming America's Professional Licensing Laws*, YALE INST. FOR SOC. AND POL'Y STUD. BLOG, https://isps.yale.edu/news/blog/2013/11/is-the-us-%E2%80%9Cover-licensed%E2%80%9D-the-case-for-reforming-america%E2%80%99s-professional-licensing (last visited Jan. 16, 2025).

obtain a government-issued fishing license to fish to preserve fish habitats from externalities the fisherperson may generate (such as overfishing).[234] Potentially unsophisticated investors simply do not generate the types of externalities that typically warrant government-mandated licenses. This does not mean that a licensing approach is a bad approach, but it is an outlier. For those concerned the accredited-investor definition is a violation of personal liberty and economic autonomy, the certification exam should do little to assuage their concerns.

3. Geographic Bias

The wealth thresholds are "not felt evenly"[235] in all geographic areas of the United States. Due to different costs of living and competitive wages throughout the country, the wealth thresholds may not treat similarly situated individuals equally based on where those individuals happen to live. Joseph O'Connor Gill offers the following example:

> [I]nvestors A and B might have the exact same job responsibilities at the exact same company. Both have no debt, attended the same university, and received the exact same degrees. Yet investor A works at the company's New York office making over $200,000 a year, while investor B works out of the Sioux City, Iowa office and makes only $160,000. The New York investor would be able to gain

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234. *See* Josh Clark, *Why Do You Need a License to Fish?*, MAPQUEST TRAVEL, https://www.mapquest.com/travel/outdoor-activities/fishing/fish-conservation/responsible-fishing/fishing-license.htm (last visited Jan. 16, 2025) (explaining that fishing licenses are required to protect fishing habitats by placing limits on "the species and amount any given fisher[person] can catch and keep in a day."); *see also Fishing Licenses: Why They are Important and How to Get One*, DISCOVER BOATING https://www.discoverboating.com/resources/fishing-licenses (last visited Jan. 16, 2025).

235. *See Sophistication or Discrimination? How the Accredited Investor Definition Unfairly Limits Investment Access for the Non-wealthy and the Need for Reform Hearing Before the Subcomm. on Fin. Servs. of the H. Comm. on Fin. Servs.*, 118th Cong. 6 (2023) (statement of Jennifer J. Schulp, Director of Financial Regulation Studies, Cato Institute Center for Monetary and Financial Alternatives) [hereinafter Schulp Testimony], https://www.congress.gov/118/meeting/house/115288/witnesses/HHRG-118-BA16-Wstate-SchulpJ-20230208.pdf.

accredited investor status due to his income level, while the Sioux City investor would not.[236]

An individual is more likely to qualify as an accredited investor under the wealth threshold when living in the West or Northeast regions. Lower costs of living in other geographic regions lead to lower wages and, therefore, disproportionately fewer accredited investors.[237] Table 5 shows median household income and net worth by U.S. region.[238]

Table 5: U.S. Household Income and Net Worth (by Region)

	West	**Northeast**	**Midwest**	**South**
2023 Median household income[239]	$88,290	$86,250	$81,020	$73,280
2019 Median household net worth (including primary residence)[240]	$114,300	$154,500	$103,200	$87,000

The SEC is keenly aware of this issue. In the proposed rule release for the 2020 Amendments, the SEC asked, "Should we take into account income disparities that may be attributable to different costs of living across the country in establishing financial thresholds in the accredited investor definition?"[241] The 2019 SEC Government-Business Forum on Small Business Capital Formation recommended that the wealth thresholds be "scale[d] for geography, lowering the thresholds in states/regions with a lower cost of living."[242] Commenters to the SEC's proposal for the 2020 Amendments echoed the suggestion to lower the wealth thresholds for certain regions to account for the income/wealth

236. Joseph O'Connor Gill, Note, *The Perfect Union: An Expansion of the Accredited Investor Definition and Potential Impacts on the Emergent Tokenized Real Estate Market*, 107 IOWA L. REV. 2311, 2343 (2022).

237. *See* Release No. 33-10734, *supra* note 225, at 2608.

238. *See infra* Table 5.

239. Gloria Guzman & Melissa Kollar, *Income in the United States: 2022-Current Population Reports*, U.S. CENSUS BUREAU 2 (September 2024), https://www.census.gov/library/publications/2024/demo/p60-282.html.

240. Release No. 33-10734, *supra* note 225, at 2595.

241. *Id.* at 2596.

242. SEC OFF. OF ADVOC. FOR SMALL BUS. CAP. FORMATION, REPORT ON THE 38TH ANNUAL GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION 8 (2019), https://www.sec.gov/files/small-business-forum-report-2019.pdf.

disparity, and so have others.[243] The SEC ultimately decided not to pursue a geographic adjustment because it believed "the complexities that geography-specific financial thresholds would create for issuers and investors do not weigh in favor of adding such geography-specific financial thresholds to the accredited investor definition at this time."[244] However, the SEC did note that it "will have the opportunity to further consider this issue in connection with its quadrennial reviews of the accredited investor definition."[245]

This article's proposal would partially mitigate the geographic disparity issue by providing an alternative pathway for nonaccredited investors in lower-income regions to become accredited investors. And this article's proposal does not involve the complexity of geography-specific financial thresholds.

4. Racial and Ethnic Bias

Accredited investors are also disproportionately white[246] or Asian. Generations of systemic inequality and discrimination have led to substantial gaps in income and net worth across racial and ethnic groups. Asian and White households are far more likely to include accredited investors than Hispanic and Black households. Table 6 shows median household income and net worth by race and ethnicity.[247]

Table 6: U.S. Household Income and Net Worth, by Race and Ethnicity

	Asian	**White**	**Hispanic**	**Black**
2023 Median household income[248]	$112,800	$89,050	$65,540	$56,490
2021 Median household net worth (including primary residence)[249]	$320,900	$250,400	$48,700	$27,100

243. *See, e.g.*, SEC Small Business Capital Formation Letter, *supra* note 178, at 1; Da Kui Letter, *supra* note 192, at 5; *see also* Gill, *supra* note 238, at 2345-47.
244. Release No. 33-10824, *supra* note 13, at 64254.
245. *Id.*
246. Schulp Testimony, *supra* note 237, at 6-7.
247. *See infra* Table 6.
248. Guzman & Kollar, *supra* note 241, at 2.

The accredited-investor definition for natural persons should recognize this racial and ethnic disparity and provide meaningful pathways for everyone, regardless of race or ethnicity, to participate in the Rule 506 market if that is what they desire. This article's proposal provides such a meaningful pathway.

V. OPTING OUT OF BEING TREATED AS NONACCREDITED INVESTORS

This article's fundamental proposal is simple: natural persons should have the freedom to waive the investor protections that come from registration. Rather than treat the accredited-investor definition as a bright line for determining who can invest in the Rule 506 market and who is excluded, the definition should serve as a default rule from which an investor can choose to opt out. By treating the accredited-investor definition as a waivable default rule, the SEC could clearly communicate its concerns to potentially vulnerable investors without having to strip away their economic autonomy.

A. DIFFERENT WAYS TO PROTECT INVESTORS

While there is some debate about the ultimate goal of securities regulation, few would disagree that protecting investors is part of the effort. Federal securities law grew from a desire to protect investors.[250] How the federal government protects investors, however, differs when regulating the registered market compared to when it regulates the unregistered market.

For the registered market, federal securities law employs a heavy and comprehensive regulatory approach. It primarily protects investors by improving the registered market's efficiency. By promoting efficiency, federal securities law creates a safer investing environment for all investors, including unsophisticated ones. This is the result of the

249. Rakesh Kochhar & Mohamad Moslimani, *Wealth Surged in the Pandemic, But Debt Endures for Poorer Black and Hispanic Families: Overall, 1 in 4 Black Households and 1 in 7 Hispanic Households in the U.S. Either had no Wealth or were in Debt in 2021*, PEW RESEARCH CENTER 14 (Dec. 4, 2023), https://www.pewresearch.org/wp-content/uploads/sites/20/2023/12/RE_2023.12.04_Race-Wealth_Report.pdf.

250. The original federal securities statute, the Securities Act, "became known as the 'Truth in Securities' Act." THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 19 (Hornbook Series, 8th ed. 2021). The Securities Act has also been characterized as the "first true consumer protection law." *Id.*

efficient market theory,[251] which posits that the current price for a security trading on an efficient market reflects all the publicly available information at the time.[252] Economist Paul Samuelson explains:

> If intelligent people are constantly shopping around for good value, selling those stocks they think will turn out to be overvalued and buying those they expect are now undervalued, the result of this action by intelligent investors will be to have existing stock prices already have discounted in them an allowance for their future prospects. Hence, to the passive investor who does not himself search out for under- and overvalued situations, there will be presented a pattern of stock prices that makes one stock about as good or bad a buy as another. To that passive investor, chance alone would be as good a method of selection as anything else.[253]

In short, the price of securities trading on efficient markets should be reasonably accurate,[254] which means an investor assembling a

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251. The efficient market theory is commonly traced to Eugene Fama's seminal piece, *The Behavior of Stock-Market Prices*, 38 J. OF BUS. 34, 34 (1965). In the article, Fama explains that "a situation where successive price changes are independent is consistent with the existence of an 'efficient' market for securities, that is, a market where, given the available information, actual prices at every point in time represent very good estimates of intrinsic value." *Id.* at 90.
While not using the term "efficient market theory" or "efficient market hypothesis," "[t]hat line set off a theoretical explosion in university economics departments." Ann C. Logue, *Are Markets Efficient? How Eugene Fama Kicked Off a Controversy*, BRITANNICA MONEY (December 11, 2023), https://www.britannica.com/money/what-is-the-efficient-market-hypothesis.

252. The summary of efficient market theory above is of "semi-strong-form efficiency," the most widely accepted version of the theory. The other forms of the efficient market theory are: (a) "strong-form efficiency," which provides that the current stock price reflects all relevant information about the stock, even if not publicly available; and (b) "weak-form efficiency," which provides that the current stock price reflects all past market prices and data (in effect, technical analysis is of no use). *See* Logue, *supra* note 253.

253. *Mutual Fund Legislation of 1967: Hearing on S. 1659 Before the S. Comm. on Banking and Currency*, 90th Cong. 370 (1976) (additional Data Submitted for the Record by Paul A. Samuelson to supplement his Written Testimony), https://babel.hathitrust.org/cgi/pt?id=uc1.31210019436904&seq=1.

254. If the elements of an efficient, or competitive, market are present, it is reasonable to assume that buyers and sellers in the past transactions will, in the aggregate, agree to an appropriate market price. The more efficient the market, the more reliable the market price. The less efficient the market, the less reliable the market price. Typical characteristics for a competitive market are: (a) there are numerous

securities portfolio by randomly picking securities should be okay (since the securities will be priced fairly) and might even do as well as an investor advised by a market professional. Market efficiency protects investors with more accurate securities pricing, which explains why mandatory disclosure plays such a central role in the registered market's regulation. The more truthful public information that is made available, the more the market can digest the information and establish a more accurate market price for everyone.

For the unregistered market generally, and the Rule 506 market specifically, the federal government takes a more minimalistic regulatory approach. Rather than employ a comprehensive regulatory scheme to promote market efficiency, the law largely protects investors through exclusion. For the Rule 506 market, the law fundamentally bans from investing those individuals who the government deems are not financially sophisticated. Those deemed financially sophisticated (i.e., accredited investors) can participate in the Rule 506 market and are left to their own devices to develop private solutions to any problems they may encounter. For accredited investors in the Rule 506 market, the role for securities laws is largely limited to policing for fraud.[255] Those deemed financially unsophisticated (i.e., nonaccredited investors), on the other hand, are mostly excluded. The regulatory goal is not to create a safe and efficient market. The goal is to sort financially sophisticated investors from unsophisticated ones, and then let the sophisticated investors protect themselves.

Is sorting investors into "favored and disfavored classes"[256] an appropriate function for the SEC? At least one SEC commissioner thinks the answer is no. In a statement issued in connection with the 2020 Amendments, SEC Commissioner Hester Peirce stated her discomfort with the SEC playing that role.

> 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 do with their money? The alleged justification is investor

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buyers and sellers; (b) each of the buyers and sellers is well informed about the merits of the transaction; (c) the traded items are homogeneous (or fungible); (d) the buyers and sellers are independent, profit-maximizers who negotiate at arm's length; and (e) the transaction costs for making an exchange are low. *See* WILLIAM J. MURPHY ET AL., PATENT VALUATION: IMPROVING DECISION MAKING THROUGH ANALYSIS 191 (2012).

255. *See* Rodriques, *supra* note 9, at 405, 408.

256. Vollmer, *Abandon the Concept of Accredited Investors*, *supra* note 111, at 15.

> protection: people can't lose their money on investments if they aren't allowed to invest. Yes, that is true, but where does that principle take us? Someone who does not invest at all will not lose any money on investments. She will, however, lose. She will lose the opportunity to see her money grow more than it could sitting in a bank account. She will lose the opportunity to be part of enterprises that she believes will transform society. And she will lose her right to make decisions for herself.[257]

Sorting investors into classes is a paternalistic function. The SEC is substituting its decision (do not invest) for the potential individual decisions that hundreds of millions of nonaccredited investors may have chosen to make for themselves. The SEC's regulatory treatment of nonaccredited investors is comparable to the common law's treatment of infants and contracts.[258] The common law generally excludes infants (natural persons under 18 years old) from forming binding contracts[259] because infants are deemed to "not possess the discretion and experience of adults and therefore must be protected from [their] own contractual follies."[260]

Rather than firmly sort investors into two distinct classes, and infantilizing most Americans, a more appropriate regulatory tool for the Rule 506 market would be to warn potentially vulnerable investors of the hazards involved with investing in that market. Government mandated warnings "alert us to the risks of eating unhealthy foods, smoking cigarettes, taking prescription drugs, driving cars, using power

257. Hester M. Peirce, Comm'r, SEC, Statement on Amending the "Accredited Investor" Definition (Aug. 26, 2020), https://www.sec.gov/newsroom/speeches-statements/peirce-accredited-investor-2020-08-26.

258. Thaya Brook Knight makes a similar point, stating:

> "Having assets that are legally deemed to be too risky or complex for one person to purchase but not another is patently paternalistic. Other areas of the law that operate this way are those that apply to children. It is legal for an adult to buy tobacco or alcohol but illegal for a child to do so. Such restrictions typically stem from the understanding that children developmentally lack adequate judgment to recognize the harm these products could cause them."

Knight*, supra* note 69, at 25.

259. RESTATEMENT (SECOND) OF CONTRACTS § 14 (AM. L. INST. 1981) ("Unless a statute provides otherwise, a natural person has the capacity to incur only voidable contractual duties until the beginning of the day before the person's eighteenth birthday.").

260. Porter v. Wilson, 106 N.H. 270, 271 (1965).

tools, and performing many other activities."[261] Rule 506 is an inherently risky market and may not be suitable for many investors, maybe even most investors. The SEC should seek to protect potentially vulnerable investors from the market's dangers, but it should try to do so without infringing on individuals' economic autonomy. Individuals should ultimately decide what and how much to invest. The SEC can both protect potentially vulnerable investors and respect economic autonomy with a very strong warning tool, which is what this article proposes.

B. MECHANICS OF THE OPT-OUT PROPOSAL

In developing this article's proposal, this author has tried to craft a solution that is easily implementable and that will not disrupt the current Rule 506 market. Thus, the proposal does not suggest making any fundamental changes to the Rule 506 exemptions themselves, nor does it involve any substantial administrative costs, such as designing and administering a certification exam or creating geography-specific financial thresholds. Instead, this proposal simply provides a straightforward path for nonaccredited investors who are natural persons to opt out of being treated as nonaccredited investors. The proposal would be simple and inexpensive to administer.

To implement the proposal, the SEC could amend the accredited-investor definition to include a new paragraph to Rule 501(a) (the "Opt-Out Paragraph") that certifies as an accredited investor any natural person who voluntarily waives the right to be treated as a nonaccredited investor and signs a statement, prepared by the SEC, that notifies the investor of the risks associated with investing in the Rule 506 market ("Opt-Out Accredited Investors"). Opt-Out Accredited Investors would be required to separately opt out for each Rule 506 transaction they wish to participate in as accredited investors. The waiver would only be valid for a single transaction.

The SEC notification/warning statement could include points such as the following:

261. Lisa A. Robinson et al., *Consumer Warning Labels Aren't Working*, HARV. BUS. REV. (Nov. 30, 2016), https://hbr.org/2016/11/consumer-warning-labels-arent-working#:~:text=In%20the%20United%20States%2C%20beginning,Cigarette%20warnings%20emerged%20in%201966.

- The Rule 506 market is not an efficient market. The Rule 506 market suffers from various market problems such as information asymmetries, agency problems, and extreme uncertainty, and, unlike the registered market, it does not benefit from a comprehensive regulatory system to reduce those problems and foster market efficiency. Investors in the Rule 506 market are on their own to fashion their own solutions to the market's problems.

- Investors who are not comfortable fashioning their own solutions to the Rule 506 market's problems should limit themselves to investing in the registered market.

- The Rule 506 market's inefficiency can lead to a greater variance in pricing accuracy than is likely to occur in the registered market.

- Many issuers in the Rule 506 market have little to no operating history, which makes valuing such companies unavoidably difficult.

- Accredited investors are not entitled to any mandatory, specified disclosure from the issuer.

- The ability to sue the issuer or its agents for misstatements or omissions in connection with a Rule 506 transaction can be more challenging than in connection with a registered transaction.

- Securities sold in Rule 506 transactions are highly restricted and difficult to resell. Moreover, equity securities in Rule 506 transactions frequently do not pay dividends. As a result, Rule 506 investments may involve very long investment horizons.

- Securities sold in Rule 506 transactions may be more complex and harder to understand than many securities sold through the registered market.

- Financial professionals who may have recommended this transaction may suffer from conflicts of interest that cause their interests to be misaligned with investors.

By treating the accredited-investor definition as a default rule, the SEC maintains its power to identify and protect potentially vulnerable investors without having to resort to a form of economic segregation that, as of 2022, denies approximately 80% of Americans the freedom to pursue potential wealth gains from investing in the Rule 506 market. The potentially vulnerable investors begin as nonaccredited and only lose that status if they affirmatively opt out. Moreover, the opt-out procedure gives the SEC the opportunity to provide a clear and strong warning to such investors. For a warning to be effective, it needs to convey to its audience, in a meaningful way, the "requisite risk information, allowing people to decide for themselves whether an activity or a product's benefits outweigh its risks, whether to take those risks, and, if so, with what precautions."[262] However, warnings (including government outreach efforts to educate the public) are everywhere, and the public has gotten very good at tuning them out.[263] If the warning tool is to be taken seriously, it must provide useful, easy-to-understand information and be designed in a way to ensure that investors hear it clearly. This opt-out approach amplifies any SEC warning in several ways:

- First, such investors are not immediately allowed to participate but must affirmatively opt out of being treated as nonaccredited investors.
- Second, such investors would have to sign an SEC-designed document that spells out the risks associated with investing Rule 506 transactions.
- Third, Opt-Out Accredited Investors would be required to separately opt out for each Rule 506 transaction such investors wish to participate in. Thus, they would be given multiple opportunities to hear and think about the risks.

Opt-Out Accredited Investors would be treated the same as other Rule 501(a) accredited investors. For example, if any Opt-Out Accredited Investors participate in a Rule 506(b) transaction, the issuer would not be allowed to engage in a general solicitation to find them, and they would not be entitled to any mandatory, specified disclosure.

C. PHASE IN THE OPT-OUT PROPOSAL

This proposal is a significant departure from how federal securities law and the SEC has historically regulated the Rule 506 market. Rule

262. *Id.*
263. *Id.*

506 has always treated the Rule 506 market as being so hazardous that most individuals must be shielded from it regardless of their personal desires. Rule 506 has never given a nonaccredited investor the option of just saying "no thank you" to being protected. Some may worry that this proposal exposes nonaccredited investors to inordinate risk and fraud. While this author believes such concerns are well-intentioned but overblown, a better way to deal with the situation is with actual proof. This article suggests running a limited trial-and-error test to find out if currently nonaccredited investors can decide for themselves how best to invest their own money. Thus, this article suggests phasing in the proposal through two stages: (1) Stage 1—start with Rule 506(b); and (2) Stage 2—include Rule 506(c).

1. Stage 1—Start with Rule 506(b)

During Stage 1, the opt-out proposal would only apply to transactions conducted under Rule 506(b). A big concern about expanding the accredited-investor definition is exposing potentially vulnerable individuals to fraud and other predatory behavior. A pool of less-rich individuals intuitively feels less sophisticated and more vulnerable to fraud. Some have expressed similar fraud concerns due to inflation expanding the accredited-investor pool.[264] In the proposed rule release for the 2020 Amendments, the SEC considered that concern and said, "While the effects of inflation have expanded the pool of accredited investors, we are not aware from our enforcement experience or otherwise of disproportionate fraud in this expanded space."[265]

The SEC's findings suggest that fraud concerns may be overstated. Nevertheless, a trial-and-error test would provide a more definitive answer to such concerns. Because Rule 506(b) does not allow general solicitations, the pool of nonaccredited investors who could opt out would be shallower. The pool would be shallower because it is effectively limited to individuals who have a pre-existing, substantive relationship with the issuer (or a person acting on its behalf). The issuer or its agents cannot advertise or generally solicit to find the nonaccredited investors who may wish to become Opt-Out Accredited

264. *See, e.g.*, Letter from Pub. Investors Arb. Bar Ass'n to Vanessa Countryman, Sec'y, SEC 3-6 (Sept. 24, 2019), https://www.sec.gov/spotlight/sbcfac/recommendation-accredited-investor.pdf; Comm'r Lee Accredited Investor Statement, *supra* note 19.

265. Release No. 33-10734, *supra* note 225, at 2600.

Investors. The issuer or its agents must already have a significant relationship with such investors. This reduces the risk for Stage 1 in several ways:

- Fewer individuals who can opt out reduces the risk exposure to the pool of currently nonaccredited investors.
- Fewer individuals who can opt out makes it easier for the SEC to monitor the initial period of the test.
- The close relationship between the issuer (or its agents) and the nonaccredited investors should reduce the risk of the issuer (or its agents) engaging in predatory behavior to bring such investors into unsuitable deals. The nonaccredited investors would not be exposed to random deals. They would only be exposed to deals from individuals with whom they have preexisting substantive relationships.
- Rule 506(b) issuers sometimes hire brokers[266] as placement agents to borrow the broker-dealer's pre-existing, substantive relationships and expand the potential pool of investors. When that occurs, the broker-dealer will have a duty of suitability to the nonaccredited investors[267] that also mitigates the fraud/predatory behavior risk.

266. Brokers are the standard intermediary for securities transactions. Exchange Act section 3(a)(4) defines a broker as any person (including legal entities), other than a bank, that is "engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4). Brokers are heavily regulated entities that must register with the SEC and become members of Financial Industry Regulatory Authority (FINRA). 15 U.S.C. § 78o(a)(1); 15 U.S.C. § 78o(b)(8).

267. The standard broker suitability duty is captured in FINRA Rule 2111. FINRA, Rule 2111 (2020), https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111. FINRA offers the following description:

> FINRA Rule 2111 requires that a firm or associated person have a reasonable basis to believe a recommended transaction or investment strategy involving a security or securities is suitable for the customer. This is based on the information obtained through reasonable diligence of the firm or associated person to ascertain the customer's investment profile. . . .

Suitability Overview, FINRA, https://www.finra.org/industry/suitability (last visited Jan. 16, 2025).

2. Stage 2—Include Rule 506(c)

Stage 1 would serve as a proof-of-concept. Assuming no serious problems occur during Stage 1, Stage 2 would follow a reasonable time after Stage 1 is introduced. During Stage 2, the opt-out proposal would expand to include both Rule 506(b) and Rule 506(c) transactions. If addressable concerns arise during Stage 1, the SEC could address them before rolling out Stage 2.

D. SECURITIES ACT SECTION 2(A)(15)

Implementing this proposal requires dealing with Securities Act section 2(a)(15).[268] Congress empowers the SEC to define "accredited investors" with section 2(a)(15), which states:

> The term "accredited investor" shall mean—
>
> (i) a bank as defined in section 77c(a)(2) of this title whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 . . . or a business development company as defined in section 2(a)(48) of that Act . . . ; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974 . . . , if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act . . . , which is either a bank, insurance company, or registered investment adviser; or
>
> (ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.[269]

The SEC's authority to craft the natural-person accredited-investor definitions stems from section 2(a)(15)(ii).[270] Subparagraph (ii) does not

268. 15 U.S.C. § 77b(a)(15).
269. *Id.*
270. *Id.* at (ii).

expressly empower the SEC to include the Opt-Out Paragraph, and agency rulemaking must stay within the bounds of the statutory authority conferred by Congress.[271] To implement this proposal, therefore, Congress would need to amend section 2(a)(15) or the SEC would have to resort to using its general exemptive authority under Securities Act section 28.[272] Section 28 provides the SEC with the authority, by rule or regulation, to:

> "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Securities Act] or of any rule or regulation issued under [the Securities Act], to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[273]

Given the U.S. House of Representatives willingness to pass the Equal Opportunity for All Investors Act of 2023, there is reason for optimism that Congress would amend section 2(a)(15) to implement this article's proposal. If Congress chooses not to act, however, section 28 clearly grants the SEC authority to implement it.

E. WILL THE RULE 506 MARKET WELCOME THE OPT-OUT ACCREDITED INVESTORS? WILL PRIVATE SOLUTIONS DEVELOP TO HELP THEM?

Would issuers in the Rule 506 market be interested in raising capital from Opt-Out Accredited Investors? Rule 506 issuers generally prefer receiving large contributions from a few investors rather than small contributions from lots of investors.[274] Recognizing this

271. Louisiana Pub. Serv. Comm'n v. F.C.C., 476 U.S. 355, 374 (1986) ("[A]n agency literally has no power to act . . . unless and until Congress confers power upon it.").

272. 15 U.S.C. § 77z-3.

273. *Id.*

274. *See* SEC, STAFF REPORT TO CONGRESS ON REGULATION A / REGULATION D PERFORMANCE AS DIRECTED BY THE HOUSE COMMITTEE ON APPROPRIATIONS IN H.R. REPT. NO. 116-122 16-17 (Aug. 2020), https://www.sec.gov/files/report-congress-regulation.pdf. The report found that from 2009 to 2019, Regulation D offerings (which mostly consist of Rule 506 transactions) included an average of only 10 investors and had an average offering size of $71 million. *Id. See also NASAA Report and Recommendations for Reinvigorating our Capital Markets*, NASAA 28 (Feb. 7, 2023) [hereinafter NASAA *2023 Report*], https://www.nasaa.org/wp-content/uploads/2023/

preference, NASAA questions whether more small investors would "be an attractive alternative for promising start-ups."[275] NASAA goes on to predict that smaller investors (which should include the Opt-Out Accredited Investors) "are likely to be left to the sorts of offerings that cannot attract funding from larger, more sophisticated investors."[276] This suggests that Opt-Out Accredited Investors would be excluded from the most promising Rule 506 deals.

NASAA raises a legitimate concern, and it is an issue the SEC should monitor. If NASAA's prediction bears fruit, the SEC should educate Opt-Out Accredited Investors that they are more likely to be offered less promising Rule 506 deals. That warning could be added to the list of notifications that Opt-Out Accredited Investors would be required to sign.

Alternatively, there may be scenarios where Opt-Out Accredited Investors would be welcome in promising Rule 506 deals. Business and social networks play a big role in being invited into unregistered securities transactions.[277] Issuers may want to allow friends and family who do not meet the Wealth Thresholds into their Rule 506 transactions, even if the investments are relatively small. They may also be willing to include young professionals in their networks (e.g., accountants, attorneys, dentists, or doctors) who do not yet meet the wealth thresholds. Currently, those individuals are simply excluded.

Private solutions may emerge to help the Opt-Out Accredited Investors to find access to promising Rule 506 deals and potentially thrive in the market. They may be able to join, or form, angel groups to obtain the deal flow and achieve the scale needed to participate in better deals. They could also receive the other benefits that angel groups can provide, including diversification, improved due diligence, better monitoring of management, and an ability to share costs for advisors.

Opt-Out Accredited Investors may also be able to invest indirectly in startups by investing in venture capital funds. However, there are currently restrictions on venture capital investing—such as section

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02/NASAA-Report-and-Recommendations-on-Reinvigorating-Our-Capital-Markets-2.7.23-Final.pdf.

275. NASAA *2023 Report*, *supra* note 276, at 28.

276. *Id.* at 29.

277. *See, e.g.*, Gyehyun Park & KonShik Kim, *Impacts of Startup Founders' Personal and Business Networks on Fundraising Success by Mediating Fundraising Opportunities: Moderating Role of Firm Age*, 9 J. OPEN INNOVATION: TECH., MKT., & COMPLEXITY 1, 1 (2023).

3(c)(1)[278] of the Investment Company Act of 1940[279] (the "Investment Company Act")—that may make it difficult for Opt-Out Accredited Investors to invest in most venture capital funds. The Investment Company Act regulates investment companies, which are securities issuers that engage primarily in the business of investing, reinvesting, or trading in securities.[280] Absent an exemption, investment companies must register under the Investment Company Act[281] and operate under a comprehensive regulatory system that includes public disclosures,[282] minimum capital requirements,[283] and independent director requirements.[284] To avoid this comprehensive regulatory system, most venture capital funds rely on an exception to the investment company definition and operate as private investment companies.[285] Section 3(c)(1) of the Investment Act is a popular exception that excepts from the definition of investment company a private fund that does not have more than 100 beneficial owners,[286] each of whom is an accredited investor. Venture capital funds may not be interested in admitting Opt-Out Accredited Investors since they would take up one of the 100 slots and may not contribute enough money to the fund to be worth a slot. If Opt-Out Accredited Investors are allowed, Congress may want to consider substantially raising its section 3(c)(1) beneficial-owner limit and considering other changes to its unregistered fund-management laws that could facilitate their participation in such managed funds.

Finally, in addition to Opt-Out Accredited Investors potentially being absorbed into existing private solutions, entirely new solutions may emerge. Private solutions are the common market response to market problems. So long as the benefits generated by any solutions are greater than the market problems' costs, new private solutions that

278. Investment Company Act of 1940 ("Investment Company Act") § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).

279. 15 U.S.C. §§ 80a-1 et seq.

280. Investment Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1).

281. Investment Company Act § 8, 15 U.S.C. § 80a-8.

282. *See* Investment Company Act § 29, 15 U.S.C. § 80a-29.

283. *See* Investment Company Act § 14(a), 15 U.S.C. § 80a-14(a).

284. Investment Company Act § 10(a), 15 U.S.C. § 80a-10(a).

285. *See e.g.*, Stacey Song et al., *Securities Law Fundamentals for Venture Capital Fund Managers*, TheFundLawyer: Cooley (Apr. 2, 2024), https://thefundlawyer.cooley.com/securities-laws-fundamentals-for-venture-capital-fund-managers/ (last visited Jan. 16, 2025).

286. Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).

would assist this expanded pool of accredited investors should develop. New intermediaries may form to reduce problems that are specific to Opt-Out Accredited Investors, new customs may develop, and/or new private contractual arrangements may emerge.

Predicting the specific, new private solutions is difficult. During the early 1990s, no one was predicting that angel groups were going to grow and become an important part of the angel finance ecosystem. However, as more angels, including more inexperienced angels, began entering the startup financing markets, their demand for specific intermediary services led to the proliferation of angel groups.[287] During the late 1990s and early aughts, no one was predicting that accelerators were going to spring up and play an important role in jumpstarting early-stage startups. Yet demand for specific services for early-stage startups led to the development of Y Combinator, Techstars, and a whole host of accelerators.[288] During the early aughts, no one was predicting that deferred equity financial instruments were going to become a common alternative to stock for financing early-stage startups. But, once again, demand drove their development as there was a substantial need for a solution to allow investors to thoughtfully invest in startups that are so young that they cannot be confidently valued.[289]

Until the Opt-Out Accredited Investors exist and their specific service demands are known, it is hard to predict the specific private solutions that will arise. In each of the above examples, individual actors came up with useful solutions based on self-interested decisions to address actual demand for services. For a new class of Opt-Out Accredited Investors, it may take years for comparably useful services to develop. One reason for this article's phase-in recommendation is to give the market time to adapt to a new class of Opt-Out Accredited Investors, and for private solutions to develop, before expanding the proposal to a broader population.

287. *See generally* Christopher Mirabile, *7 Reasons Why Angel Investing Became Serious Finance*, INC. (Aug. 25, 2014), https://inc.com/christopher-mirabile/how-angel-investing-became-serious-finance-seven-factors.html.

288. *See generally* Ian Hathaway, *Accelerating Growth: Startup Accelerator Programs in the United States*, BROOKINGS (Feb. 17, 2016), https://www.brookings.edu/articles/accelerating-growth-startup-accelerator-programs-in-the-united-states/.

289. Orcutt, *Valuing Young Startups*, *supra* note 152, at 470-71, 477.

CONCLUSION

With the current accredited-investor definition, the SEC replaces individual decision-making with a blunt, protective rule. To protect investors, it draws a bright line between who can, and who cannot, invest in the Rule 506 market. Such a bright dividing line could never hope to be perfect. It could never hope to capture all the variables and intricacies that go into each individual's personal investing abilities. Over- and under-inclusion are unavoidable results. If the SEC tries to reduce the over-inclusion problem by creating a less-inclusive bright line, it will certainly exacerbate the under-inclusion problem. If the SEC tries to reduce the under-inclusion problem with a more-inclusive bright line, it will also increase over-inclusion. There is no perfect dividing line and there never will be, so why not soften the line's brightness?

This article recommends that natural persons be given the freedom to waive the investor protections that come from registration. Rather than treat the accredited-investor definition as a bright line for sorting investors into favored and disfavored classes, the definition should serve as a default rule. Making the accredited-investor definition a waivable default rule allows the SEC to protect potentially vulnerable investors by clearly telling them when the Rule 506 market may be unsuitable, which could even include raising the bar on who automatically qualifies as accredited (such as by indexing the wealth thresholds to inflation and/or implementing tailored solutions for the elderly). At the same time, competent individuals who disagree with the SEC's concerns—and who are most familiar with their own financial sophistication, risk tolerance, and finances—could voluntarily choose to be accredited investors and opt out of being shielded from risky investments.

The U.S. capital markets' strength and the SEC's regulatory effectiveness have been built on competitive markets that allow self-interested buyers and sellers to determine for themselves what transactions to engage in. The SEC was never envisioned to serve as a merit-based regulator that screens deals, and yet it effectively plays that role when it draws a bright line to sort individuals into those who can, and those who cannot, invest. This proposal will allow the SEC to get out of that merit-based regulatory role and do what it does best, which is ensure that investors are informed about the investment activities they wish to pursue so they can make the best choices for themselves.