

WHY THE “ACCREDITED INVESTOR” STANDARD
FAILS THE AVERAGE INVESTOR

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I. Introduction

“The rich get richer” is a timeless truth.¹ While this may be self-evident, some of the reasons why the rich seem to get richer are less apparent. Surprisingly, U.S. securities regulations award special investment privileges to the already affluent, resulting in a legal system that makes it even easier for them to amass wealth.²

Private placements operate as one such privilege. Because most investment decisions are executed in a public marketplace, rules that govern securities market transactions can directly impact an investor’s earning capacity.³ By placing limitations on who can invest in private placements, regulators seek to protect investors and the amount of risk they can undertake.⁴ Risk and return, however, are incontrovertibly linked: if one investor is able to take advantage of investment opportunities that are unavailable to others, he or she may potentially earn larger returns.⁵ Consequently, the government’s

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¹ See Robert C. Lieberman, *Why the Rich Are Getting Richer*, FOREIGN AFFAIRS, Jan. 2011, <http://www.foreignaffairs.com/articles/67046/robert-c-lieberman/why-the-rich-are-getting-richer?page=2>.

² See *id.*

³ Robert J. Bloomfield, *The “Incomplete Revelation Hypothesis” and Financial Reporting*, 16 ACCT. HORIZONS 233, 239 (2002).

⁴ See Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REG. 345, 354 (1995). Access to better investment opportunities is just one why of explaining why a particular investor is more profitable than another. Access to better information is an important factor as well. Nonetheless, this note limits its focus to investment opportunities.

⁵ *Balancing Risk and Return to Meet Your Goals*, OFFICE OF THE ATTORNEY GEN. OF THE STATE OF N.Y., <http://www.oag.state.ny.us/investor-protection/balancing-risk-and-return-to-meet-your-goals> (last visited Apr. 5,

placement of regulatory limits on an investor's potential risks also limits that investor's potential returns.⁶

While there are many regulations currently in place that deal with risk, this note focuses on the private placement exemption and how it affords wealthier investors better investment opportunities than those available to retail investors. Part II of this note discusses the specifics of private placements and explains why the current "accredited investor" standard is ineffective. Part III expounds on the current status of retail investors and their investment opportunities. Part IV argues that retail investors should be allowed to invest in private offerings.⁷ Part V concludes with a recommendation.

II. Private Placements and Why the Current "Accredited Investor" Standard is Ineffective

Under the Securities Act of 1933 ("1933 Act"), issuers seeking public financing must either register their securities with the Securities Exchange Commission ("SEC") or meet an exemption to registration.⁸ Private placements are an exception to that general rule, as the government exempts transactions by issuers that do not involve public offerings.⁹ Generally, the primary private placement market deals in transactions that involve a limited number of sophisticated investors buying a new issue of non-public securities that are exempt from registration.¹⁰ Regulation D—promulgated by the SEC in order to institute safe harbors for issuers of private placements—affords issuers one of the main ways to qualify for exemptions.¹¹ This note will limit its discussion to the "accredited

2012). If one investor is allowed to invest in a security that will yield a 10 percent return while another one can only invest in a security that will yield a 5 percent return over the same time period, then the latter investor will generate lower returns than the first investor.

⁶ See example in *supra* note 5.

⁷ This note recognizes that retail investors may indirectly invest in private offerings by investing through institutional investor such as mutual funds, but characterizes these types of transactions as institutional investor transactions.

⁸ Securities Act of 1933, 15 U.S.C. § 77c (West 2006).

⁹ *Id.*

¹⁰ MELANIE L. FEIN, SECURITIES OF ACTIVITIES BANKS § 10.01 (4th ed. 2011).

¹¹ Markham, *supra* note 4, at 354–55.

investor” standard used in Regulation D offerings, which are responsible for many registration exemptions today.

A. Regulation D Offerings

Regulation D exemptions are private placements that allow issuers to issue securities to private investors without undergoing a cumbersome registration process designed to protect unsophisticated investors.¹² Through the use of private placements, an issuer may reduce its cost of issuances by avoiding the traditional registration process with the SEC for public issuances.¹³ Regulation D sets forth substantive and procedural rules, which operate to exempt certain transactions from registration.¹⁴ More specifically, Rules 505 and 506 provide registration exemptions to issuers issuing securities to “accredited investors” and up to thirty-five non-accredited investors.¹⁵

1. Who Can Invest in Regulation D Offerings?

Historically, only “sophisticated investors,” those who were able to “fend for themselves,” could invest in private placements.¹⁶ Later, the SEC developed an “accredited investor” standard for Regulation D offerings, which uses quantifiable metrics to create bright-line rules for determining whether investors are capable of fending for themselves.¹⁷

As defined, accredited investors include: financial institutions, pension plans, venture capital funds, corporations and other organizations exceeding a certain size, insider of the issuer,

¹² *Id.*

¹³ *Id.*

¹⁴ John V. Bautista, *Key Considerations in Forming a New Company*, in VENTURE CAPITAL 2012: NUTS AND BOLTS 87, 111–18 (Corporate Law & Practice Course Handbook Ser. No. 34817, 2012).

¹⁵ *Id.*

¹⁶ SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

¹⁷ *Accredited Investors*, SEC.GOV, <http://www.sec.gov/answers/accred.htm> (last visited Apr. 5, 2012).

natural persons with wealth or income exceeding certain threshold amounts and entities owned by accredited investors.¹⁸

Natural persons seeking to qualify as accredited investors must meet either net worth qualifications or income qualifications.¹⁹ To meet net worth qualifications, a natural person's net worth must exceed \$1 million, either individually or jointly with the individual's spouse.²⁰ Alternatively, a natural person must have "income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year."²¹

The reasoning behind allowing accredited investors to invest freely in Regulation D private placements is that they are deemed to possess the requisite sophistication and resources to obtain disclosure from issuers and evaluate the risks of private offerings on their own.²²

2. Are Accredited Investors Necessarily More Sophisticated?

Recent criticisms of the private placement exemption focus heavily on the idea that wealthy individual accredited investors should receive full protection under U.S. securities regulations because they are not necessarily capable of fending for themselves.²³ The dominant narrative offered as an explanation for the Great Recession of 2008—that investors took risks that they did not understand and that they were inadequately compensated for these

¹⁸ JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 283–85 (6th ed. 2009).

¹⁹ *Id.* at 284–85.

²⁰ 17 C.F.R. § 230.501(a)(5). Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act directs the SEC to "adjust the net worth standard for an accredited investor . . . so that the individual net worth of any natural person, at the time of purchase, is more than \$1,000,000 . . . , excluding the value of the primary residence of such natural person" Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010).

²¹ 17 C.F.R. § 230.501(a)(6).

²² Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 *DEL. J. CORP. L.* 151, 153 (2010).

²³ *Id.* at 155.

risks—supports this view as well.²⁴ As a result, many have advanced arguments for a reformation of our financial laws and regulations in favor of increased regulatory oversight.²⁵

An individual investor’s level of wealth does not necessarily share a positive correlation with his or her investment expertise because wealth may be obtained in a number of ways that require no investment knowledge, for instance by inheritance.²⁶ Thus, investors meeting the monetary qualifications set forth in the definition of accredited investor are not necessarily more sophisticated than retail investors.²⁷ At least for natural persons, having a certain net worth or a certain level of income does not imply an ability to obtain and evaluate issuer disclosures related to a particular security.²⁸

The justification behind allowing wealthy and potentially unsophisticated investors who can afford to lose money to invest in mispriced securities is that this exception encourages capital formation.²⁹ By using private placements to issue securities to accredited investors, issuers are able to make efficient use of capital to build their businesses.³⁰ This is partly due to the fact that issuing private placements reduces the transaction cost involved in obtaining money from capital markets since the issuers can avoid costly regulation.³¹

On the other hand, by defining accredited investors as individuals who meet certain net worth or income requirements, U.S. securities regulations limit the potential pool of investors in private placements to individuals who are deemed wealthy enough to take on

²⁴ Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk and Market Institutions*, 26 YALE J. ON REG. 445, 452 (2009).

²⁵ See generally Johnson, *supra* note 22 (questioning the wisdom of leaving private placements unregulated and urging a return of the power to regulate such offerings to the states).

²⁶ See Paul Sullivan, *Managing and Investment Portfolio of Risks, Not Only Returns*, N.Y. TIMES, Aug. 5, 2011, <http://www.nytimes.com/2011/08/06/your-money/asset-allocation/managing-risk-in-an-investment-portfolio-wealth-matters.html?ref=investments>.

²⁷ See COX, HILLMAN & LANGEVOORT, *supra* note 18, at 283–85.

²⁸ *Id.* at 258 n.1.

²⁹ Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299–300 (1994).

³⁰ *Id.* at 300.

³¹ See *infra* Part IV

higher levels of investment risk than non-accredited investors.³² Consequently, the current securities regulations balance the need for efficient capital formation against the desire to limit risks undertaken by investors.³³

In sum, accredited investors are not necessarily more sophisticated than non-accredited investors; however, accredited investors are allowed to take higher amounts of investment risk in favor of efficient capital formation.³⁴

B. Why the Current “Accredited Investor” Standard is Less Effective

In light of the above, neither net worth nor adjusted gross income are necessarily good indicators of whether a certain individual is better suited to take bigger investment risks and to absorb financial losses than another individual with a lower net worth or lower income level.

Net worth is the sum of all of an individual’s liquid and non-liquid assets minus liabilities.³⁵ Assets can be broken up into three parts: large assets, personal items and assets that are liquid.³⁶ Examples of large assets include real property and cars.³⁷ Personal items, on the other hand, can consist of items like jewelry, stamp collections and musical instruments.³⁸ Finally, liquid assets include items such as cash on hand, cash in checking or savings accounts, stocks, retirement funds and other investments.³⁹ The sum of an individual’s liquid and non-liquid assets equals his or her total asset value.⁴⁰ Similarly, to calculate an individual’s total liabilities, all of his or her liabilities must be totaled, including mortgages, car loans,

³² *See id.*

³³ *See id.*

³⁴ *See id.*

³⁵ *See* Net Worth Methods of Proof, I.R.M. 9.5.9.5.8.1 (2012), *available at* http://www.irs.gov/irm/part9/irm_09-005-009.html#d0e678 (listing non-exclusive factors to be considered in determining adjustments in net worth); Jeremy Vohwinkle, *How to Calculate Your Net Worth*, <http://financialplan.about.com/od/personalfinance/ht/networthhowto.htm> (last visited Apr. 5, 2012) (explaining how financial wealth is calculated).

³⁶ Vohwinkle, *supra* note 35.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

student loans and credit cards.⁴¹ Therefore, the net worth standard simply measures an individual’s total assets minus total liabilities, without regard for whether the assets are liquid or non-liquid.⁴²

Whether assets are liquid or non-liquid matters because non-liquid assets are more difficult to convert to cash than liquid assets.⁴³ Therefore, high net worth investors who have insufficient liquid assets may be forced to liquefy their assets for cash.⁴⁴ For example, if an investor uses liquid assets to make an investment and that investment fails to deliver expected returns to the investor, then that investor may have to liquefy non-liquid assets to meet his or her ongoing need for capital.⁴⁵ When the investor decides to convert a non-liquid asset to cash, he or she faces liquidity risk—i.e., having to sell the non-liquid asset at a significant discount in order to sell the asset quickly.⁴⁶

The adjusted gross income standard is also ineffective in determining whether a particular investor is in a position to absorb financial losses.⁴⁷ Because adjusted gross income fails to consider the full extent of an individual’s expenses, an investor may have sufficient adjusted gross income, but may not have the requisite funds to absorb financial losses.⁴⁸ For example, an individual who earns \$200,000 annually may have annual liabilities that exceed this amount.⁴⁹ An individual with less adjusted gross income who has proportionately lower liabilities is better positioned to absorb financial losses.⁵⁰

Instead, the accredited investor standard should consider whether an investor has the requisite discretionary income to risk in making investments. Discretionary income is commonly defined as an individual’s adjusted gross income minus taxes and necessities such mortgage, utilities and food cost, and should reflect the portion of his or her income that can be used for spending or saving.⁵¹ For

⁴¹ *Id.*

⁴² *Id.*

⁴³ See 69 AM. JUR. 2D *Securities Regulation—Federal* § 738 (2008).

⁴⁴ See *id.*

⁴⁵ See *id.*

⁴⁶ REAL ESTATE INVESTOR'S DESKBOOK § 2:93 (3d ed. 1994)

⁴⁷ See 26 U.S.C. § 62 (2010) (defining adjusted gross income).

⁴⁸ See *id.*

⁴⁹ See *id.*

⁵⁰ See *supra* text accompanying notes 35–42.

⁵¹ See Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax* 68 CORNELL L. REV. 429, 448–49 (1983).

example, if an individual has an adjusted gross income of \$100, is taxed \$25, and has rent, food, transportation and other living expenses that total \$60, then he or she has discretionary income of \$15. In light of this, an investor can afford to absorb losses equal to the amount of discretionary income he or she has available.⁵² In this scenario, issuers may voluntarily determine that it is not worth it for the organization to transact with an individual who only has a few dollars of discretionary income; however, the government has no reason to bar such financial transactions. If the issuer and the investor both elect to participate in the transaction and the individual has the capacity to absorb potential financial losses stemming from the investment, then that investor should be allowed to take that risk and reap the potential benefits of the investment. This may lead to better capital formation by allowing issuers to borrow from a larger pool of investors.

Since net worth standards include both the liquid and illiquid assets of a particular investor while income standards factor in his or her adjusted gross income, an investor who meets the accredited investor standard may have less discretionary income than another one who does not. For example, if A is retired and has a net worth of \$1 million, but the vast majority of A's net worth is invested in real properties—none of which A uses as a primary residence—A qualifies as an accredited investor. Or, if A is single, lives in New York City⁵³ with an annual income of \$200,000 and has four children, A qualifies as an accredited investor. On the other hand, if B is single, lives in Harlingen, Texas⁵⁴ with an annual income of \$195,000 and has no children, B does not qualify as an accredited investor.⁵⁵ Although in each example, A is an accredited investor and B is not, B is likely to have more discretionary income than A. Furthermore, even if B only has discretionary income of \$50, B should be able to invest this money as he or she pleases without unnecessary limitation.

The discretionary income standard is a better financial measure of determining whether a particular investor can afford to

⁵² *See id.*

⁵³ New York City has the highest cost of living in the country. Joe Light, *The Most and Least Expensive Cities*, WALL ST. J., Oct. 28, 2011, <http://blogs.wsj.com/totalreturn/2011/10/28/the-most-and-least-expensive-cities/>.

⁵⁴ Harlingen, Texas has the lowest cost of living in the country. *Id.*

⁵⁵ *See* COX, HILLMAN & LANGEVOORT, *supra* note 18, at 283–85.

make risky investments because it quantifies his or her capacity to absorb financial losses.⁵⁶ Moreover, by limiting a particular investor’s total investment in private placements to the precise dollar amount of that individual’s discretionary income, regulators can insure that investors who do invest in private placements can truly bear the risks of their investments. Applying a discretionary income standard in determining whether a particular investor qualifies as an accredited investor may result in better access to capital for issuers seeking investors and increase investment opportunities for retail investors.⁵⁷

III. The Current Status of Retail Investors and Their Investment Opportunities

The percentage of institutional investors relative to retail investors in the U.S. trading market is growing, which has potential advantages and disadvantages.⁵⁸

Since the 1950s, the proportion of institutional investors to retail investors in the U.S. financial markets has changed, and the percentage of retail investors’ direct ownership of securities has decreased dramatically.⁵⁹ First, institutional investors’ percentage ownership of publicly-traded securities, as well as of privately-placed securities, has increased steadily since the 1950s.⁶⁰ For instance, institutional investors held 26 percent of outstanding stock in 1956, and almost 40 percent by 1970.⁶¹ When the SEC adopted Regulation D in the 1980s,⁶² the percentage of New York Stock Exchange-traded

⁵⁶ See Friedman, *supra* note 29, at 299.

⁵⁷ This note does not compare the administrability of the discretionary income standard to that of the current accredited investor standard. If the discretionary standard is significantly more costly or difficult to implement, then it may not be the best solution. The author encourages future papers to explore the administrability of a discretionary income standard as compared to the existing accredited investor standard.

⁵⁸ See Markham, *supra* note 4, at 347–49.

⁵⁹ See *id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² See EDWARD F. GREENE ET AL., 1 U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS: UNITED STATES REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 5 n.9 (2005).

stock held by institutional investors was approximately 35 percent.⁶³ By 1990, institutional investors held 39 percent of all over-the-counter stocks and 87 percent of all privately-placed securities.⁶⁴ Second, there has been a reciprocal drop in the percentage of direct ownership of publicly-traded securities by retail investors.⁶⁵ Retail investors' ownership decreased from approximately 84 percent of outstanding securities in 1965 to approximately 53 percent in 1991.⁶⁶

Table 1: Proportion of Market Ownership by Institutional Investors⁶⁷

	Publicly-traded equities (\$21.5 trillion)	Publicly-traded debt (\$10.7 trillion)
Mutual funds	28.9%	13.4%
Public pension funds	10.0%	2.4%
Private pension funds	12.9%	2.9%
Life Insurance companies	8.0%	20.3%
Financial Institutions	1.4%	14.8%
Endowment funds		
Foreign Investment	13.0%	23.3%
Retail (individuals)	25.4%	15.2%

⁶³ Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 114 (1984).

⁶⁴ Markham, *supra* note 4, at 347–49.

⁶⁵ *See id.*

⁶⁶ *Id.*

⁶⁷ Alan Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 261 (2009) (emphasis added).

Today, retail investors directly own approximately 25 percent of publicly-traded equities and approximately 15 percent of publicly-traded debt, while institutional investors own approximately 75 percent and 85 percent, respectively.⁶⁸ Additionally, approximately 90 percent of all private placements are made to institutional investors.⁶⁹ Historical trends show that retail investors are quickly moving away from direct ownership of securities.⁷⁰ If this trend continues, retail investors’ direct ownership of securities may eventually dwindle down to negligible proportions.⁷¹

If retail investors are disappearing from the trading market, how would an all-institutional investor trading market impact the U.S. financial markets at large? The possible benefits and drawbacks are examined below. Ultimately, this note advances the idea that, based on the prevailing economic theory of supply and demand, the absence of retail investors will likely result in an increase in the cost of obtaining capital from the public.

A. Potential Advantages of the Shift in the Proportion of Retail Investors

Some commentators argue that an all-institutional investor trading market will result in several benefits such as increased market efficiency, better corporate governance and decreased need for securities regulation.⁷²

1. Market-Efficiency

Commentators argue that an all-institutional investor market would be more efficient than a market that includes retail investors.⁷³ Many consider retail investors to be “noise traders” that distort share prices and harm market functioning.”⁷⁴ Pursuant to this argument, in the absence of “noise traders,” the market would be more effective at

⁶⁸ *Id.*

⁶⁹ See Markham, *supra* note 4, at 347–49.

⁷⁰ See *supra* text accompanying note 66.

⁷¹ See Markham, *supra* note 4, at 347–49.

⁷² Alicia Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1115–27 (2009).

⁷³ *Id.* at 1116.

⁷⁴ *Id.* at 1118.

setting prices because prices would be based on issuer disclosures and not fads or other types of unreliable information.⁷⁵

Based upon this theory, retail investors harm market efficiency because they make irrational trade decisions that are not grounded in valid information.⁷⁶ This theory thus predicts that a market without retail investors would become more efficient.⁷⁷

2. Better Corporate Governance

The second argument in favor of an all-institutional investor market is that such a market would ensure better corporate governance.⁷⁸ The reasoning behind this argument is that institutional investors have greater ability to monitor issuer corporations because they are sophisticated market actors and have greater bargaining power.⁷⁹ Because institutional investors are more sophisticated, an institutional investor-driven market can effectively price various forms of issuer disclosure by demanding them from the issuers.⁸⁰ Furthermore, institutional investors possess the means to better monitor issuer corporations to ensure compliance with regulatory standards for issuer disclosures in connection with an issuance.⁸¹

Underlying this argument are the assumptions that markets are efficient and that institutional investors have an incentive to monitor issuers.⁸² Critics, however, have pointed out that institutional investors have failed to monitor issuers in the past and that there is no reason to assume that an all-institutional investor market will promote better corporate governance.⁸³

⁷⁵ *See id.* at 1118 n. 49.

⁷⁶ *See id.*

⁷⁷ *Id.* at 1115–19.

⁷⁸ *Id.* at 1122–25. *See generally* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009) (exploring the idea that an “anti-fraud only” regulatory scheme would emerge from an all-institutional investor trading market and arguing that institutional investors could demand proper issuer disclosures in such a market).

⁷⁹ *See id.*

⁸⁰ Evans, *supra* note 72, at 1122.

⁸¹ *Id.* at 1124–25.

⁸² *Id.*

⁸³ *Id.* at 1123.

3. Decreased Need for Securities Regulation

The third argument in favor of an all-institutional investor market is that such a market would not require as much regulation.⁸⁴ Because an all-institutional investor market could demand and properly price needed issuer disclosures, it would not require as much regulatory protection.⁸⁵ This is because institutional investors are deemed to be sophisticated and able to fend for themselves, which means that they are able to determine which disclosures are necessary to make informed investment decisions.⁸⁶

Furthermore, institutional investors would be better suited to absorb losses from issuer wrongdoing—such as issuer fraud—because they are more likely to hold diversified investments.⁸⁷ Stated differently, unlike undiversified investors, institutional investors have other investments to spread the losses over.

From the corporate issuer’s perspective, the benefit of less regulation is that market actors will have fewer regulations to comply with, which will in turn reduce the costs of regulatory compliance.⁸⁸ Overall, this may lead to more efficient capital formation and access to cheaper capital for issuers that are able to offer more attractive rates for private placements to institutional investors.

B. Potential Disadvantages of the Shift in Proportion of Retail Investors

While there are potential advantages of an institutional investor driven trading market, there are also arguments for potential disadvantages such as increased cost of obtaining capital, decreased market efficiency and a decline in the quality of corporate governance.

⁸⁴ *Id.* at 1125.

⁸⁵ *See id.* at 1122–25.

⁸⁶ *See supra* text accompanying note 16.

⁸⁷ Evans, *supra* note 72, at 1125–27.

⁸⁸ *See id.*

1. Increased Costs of Obtaining Capital

In an all-institutional investor market, the cost of obtaining capital from financial markets would likely rise. If an issuer's supply of investment capital is channeled entirely through institutional investors, then issuers will have to obtain capital from a limited supply of investors.⁸⁹

As with any supply and demand curve, if the supply of investors decreases and the demand for investors remains the same, then the supply curve must shift so that the cost of obtaining capital from investors would increase and the quantity of investors would decrease. If a decrease in the number of investors leads to issuers paying a higher cost for capital, then issuers' total costs of production will also rise because the cost of obtaining financing is a factor in determining the total cost of production.⁹⁰

Conversely, in a market where retail investors participate in trades, issuers have access to a larger pool of investors, resulting in a lower cost of obtaining capital from the financial market. It logically follows that if a larger number of retail investors were to participate in trades, then the supply of investors would increase, shifting the supply curve and lowering the cost of obtaining capital from the financial markets.⁹¹

2. Decreased Market Efficiency

A minority of commentators argues that retail investors can bring "relevant private information" to the market, which helps set market prices and therefore increases market efficiency.⁹² Some additionally argue that retail investors contribute to the marketplace by increasing market liquidity.⁹³ An efficient market requires liquidity.⁹⁴ By providing additional liquidity, retail investors therefore increase market efficiency.⁹⁵ Conversely, the exclusion of

⁸⁹ *See id.* at 1122.

⁹⁰ *See Production and Costs: The Theory of the Firm*, STATE UNIV. OF N.Y. OSWEGO, <http://www.oswego.edu/~atri/production.html> (last visited Apr. 2, 2012).

⁹¹ *See id.*

⁹² Evans, *supra* note 72, at 1119.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *See id.*

retail investors should result in decreased market liquidity and a less efficient market.⁹⁶

Because institutional investors often execute large trades, there are also concerns that liquidity would be in short supply in an all-institutional investor market.⁹⁷ Institutional investors may experience difficulty in finding counterparties for large trades.⁹⁸ As a result, they are sometimes forced to “[lower] their ask price or [raise] their bid price in order to attract interest from other investors.”⁹⁹ Because of the higher liquidity costs associated with executing large volume trades, institutional investors may create market noise that results in the mispricing of securities and a less efficient market.¹⁰⁰

3. Decline in the Quality of Corporate Governance

Critics argue that a reduction in retail investor participation in the trading market would lead to a correlating decline in the quality of corporate governance.¹⁰¹ Historically, institutional investors have been passive investors.¹⁰² Institutional investors are primarily interested in “provid[ing] retail investors with the benefits of a diversified portfolio, not . . . act[ing] on their own behalf as independent players in the financial markets[,]” remaining “largely irrelevant for corporate governance purposes.”¹⁰³ Consequently, institutional investors may not have a vested interest in actively monitoring corporate governance issues.¹⁰⁴

In contrast, retail investors do put their own money on the line in making investments, and have incentive to take action to

⁹⁶ *See id.*

⁹⁷ *See* Stavros Gadinis, *Market Structure for Institutional Investors: Comparing The U.S. and E.U. Regimes*, 3 VA. L. & BUS. REV. 311, 315 (2008).

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *See* Evans, *supra* note 72, at 1122–25.

¹⁰² Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap For Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 237 (2007).

¹⁰³ *Id.*

¹⁰⁴ *Id.*

enhance corporate governance.¹⁰⁵ Therefore, based on historical evidence, an all-institutional investor market is likely to result in worse corporate governance.¹⁰⁶

C. Consequences of the Decline in the Number of Real Investors

There are valid arguments on both sides of the debate as to the effect that the decline in the number of retail investors would have on market efficiency and corporate governance.¹⁰⁷ Both sides' arguments have merit; however, if one takes seriously the proposition that the absence of retail investors is associated with an increased cost of obtaining capital for issuers, this could also negatively affect market efficiency.

If the cost of obtaining capital for issuers rises, financial markets will probably become less efficient because market efficiency depends largely upon trading volume.¹⁰⁸ If trading volume decreases, then, market efficiency is also expected to decrease.¹⁰⁹ Trading volume is likely to decrease in a market where the cost of obtaining capital is higher because the higher cost of obtaining capital will increase the cost of trading transactions.¹¹⁰ In an all-institutional investor trading market, transaction costs are likely to increase for two main reasons: first, there will be fewer investors executing small trades providing liquidity;¹¹¹ second, the price of securities may become less stable as a result of institutional investors executing large trades.¹¹²

¹⁰⁵ See Jennifer S. Taub, *Able But Not Willing: The Failure of Mutual Fund Advisers To Advocate For Shareholders*, 34 J. CORP. L. 843, 844 (2009).

¹⁰⁶ See Evans, *supra* note 72, at 1122–25.

¹⁰⁷ See *id.*

¹⁰⁸ See *id.*

¹⁰⁹ See *id.*

¹¹⁰ See Gadinis, *supra* note 97, at 315.

¹¹¹ See *id.*

¹¹² See *id.*

IV. *Why Retail Investors Should Be Allowed to Invest in Private Placements*

In 2011, 54 percent of Americans had invested in the stock market.¹¹³ Nonetheless, the vast majority of Americans are precluded from investing in private placements because they do not meet the income standard or the net worth standard.¹¹⁴

A. *Who is the Average American Retail Investor?*

The vast majority of American households have an average income below the threshold amount of \$200,000 necessary to meet the accredited investor standard.¹¹⁵ Although the average income has steadily increased over the years from approximately \$4,000 per year in 1960 to over \$40,000 per year today, most Americans fall far short of the requisite \$200,000 per year.¹¹⁶ Indeed, in 2010, the average American household was composed of 2.58 members,¹¹⁷ and had an annual income of approximately \$42,000.¹¹⁸ As few as 5 percent of American households have sufficient income to qualify as accredited investors under the income standard.¹¹⁹

¹¹³ Dennis Jacobe, *In U.S., 54% Have Stock Market Investments, Lowest Since 1999*, GALLUP ECON., Apr. 20, 2011, <http://www.gallup.com/poll/147206/stock-market-investments-lowest-1999.aspx> (graphing the percentage of Americans invested in the stock market from 1999 through 2011).

¹¹⁴ See *infra* text accompanying note 119 (describing the percentage of Americans who meet the income standard or the net worth standard to be eligible to invest in private placements).

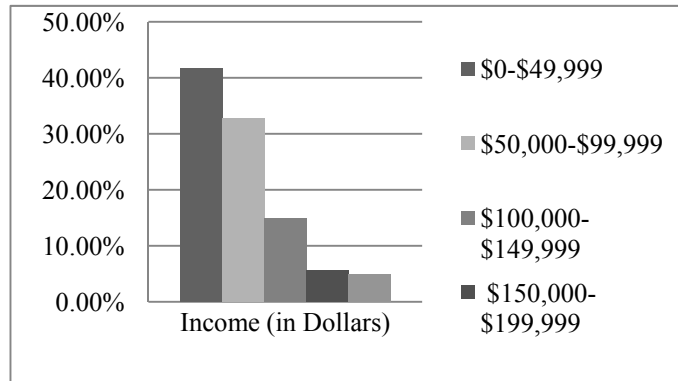
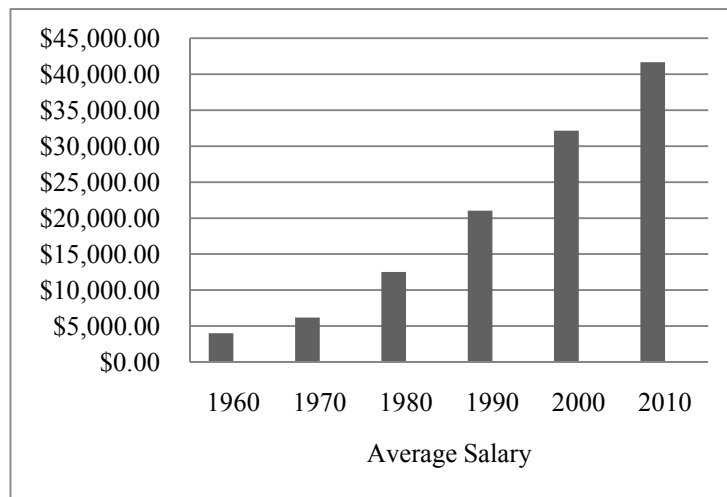
¹¹⁵ See U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2012, at 455 (2012) [hereinafter STATISTICAL ABSTRACT].

¹¹⁶ *National Average Wage Index*, SSA.GOV, <http://www.ssa.gov/oact/COLA/AWI.html> (last visited Apr. 5, 2012).

¹¹⁷ *Census Bureau Releases 2010 Census Demographic Profiles for the United States, Arkansas, Illinois, Indiana, Iowa, Louisiana, Maryland, New Jersey, Oklahoma, Oregon, South Dakota, Texas, Vermont and Virginia*, U.S. CENSUS BUREAU (May 26, 2011), http://www.census.gov/newsroom/releases/archives/2010_census/cb11-cn144.html.

¹¹⁸ *National Average Wage Index*, *supra* note 116.

¹¹⁹ See STATISTICAL ABSTRACT, *supra* note 115, at 469.

Graph 1: U.S. Income Distribution¹²⁰**Graph 2: Average Wages of Americans**¹²¹

Moreover, most Americans do not meet the net worth standard.¹²² The age group with the highest net worth is Americans between the ages of sixty-five to seventy-four,¹²³ and this is also the only group of American adults whose average net worth either meets

¹²⁰ *See id.*

¹²¹ *See National Average Wage Index, supra* note 116.

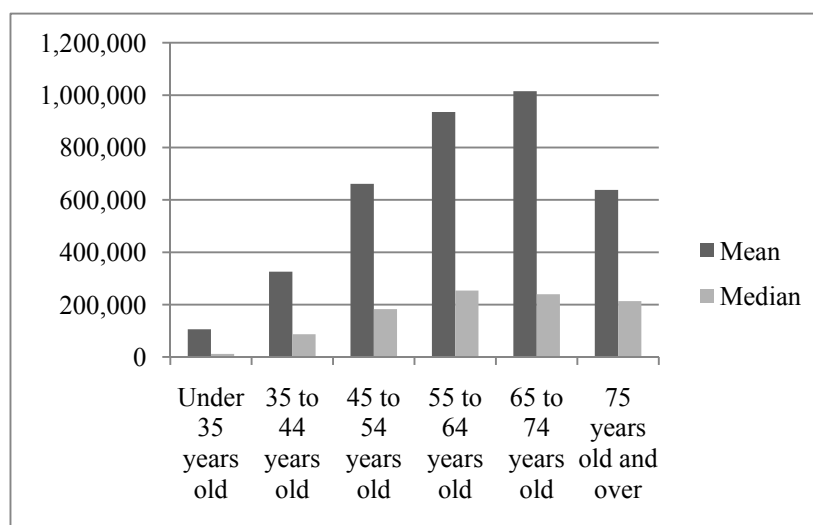
¹²² *See* STATISTICAL ABSTRACT, *supra* note 115, at 469.

¹²³ *Id.*

or exceeds \$1,000,000.¹²⁴ Despite this average, the median income within that age group is just \$239,400.¹²⁵ In addition, the U.S. population between the ages of sixty-five and seventy-four only makes up approximately 8.9 percent of the total population.¹²⁶ Thus, at most a fraction of 8.9 percent of the U.S. population is eligible to invest in private placements based on their net worth.¹²⁷

As a result, most American investors are unlikely to ever qualify to invest in private placements unless they do so indirectly through institutional investors. Furthermore, some percentage of those who qualify based on their net worth may overlap with some percentage of those who qualify based on their annual income.

Graph 3: Average Net Worth of Americans¹²⁸



B. Issuers Prefer Private Placements

Many issuers prefer to raise capital in the private placement market because it is cheaper than raising money through public

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *See id.*, at 55.

¹²⁷ *See id.*

¹²⁸ *See id.* at 469.

issuances.¹²⁹ In addition, private placements allow issuers to “preserve confidentiality, avoid the necessity of obtaining a rating, issue securities with complicated or unusual terms, avoid delays associated with registration, and delay take-down of funds.”¹³⁰ Because of the many advantages associated with raising capital in the private placement market, issuers have increasingly turned to private placements to raise capital, creating a larger private placement market.¹³¹ “As of 2006, the dollar amount of unregistered equity shares sold through private placements in the U.S.—\$162 billion—exceeded the \$154 billion raised in public offerings on U.S. exchanges.”¹³²

For smaller issuances, the cost of registering securities with the SEC for a public offering is often at least twice the cost of certain types of private offerings.¹³³ In addition to the cost of registering securities with the SEC, public company issuers must shoulder the costs of complying with the Sarbanes Oxley Act of 2002 and its disclosure, reporting and corporate governance requirements.¹³⁴ Thus, the decision makers of some privately-owned companies might prefer to raise capital through private rather than public offerings.¹³⁵

Consequently, if it is more expensive for issuers to raise money through a public offering than a private offering, then issuers may be able to offer investors better terms for private issuances by theoretically passing on the savings from avoiding securities registration costs.

¹²⁹ FEIN, *supra* note 10, § 10.01.

¹³⁰ *Id.*

¹³¹ *See id.*

¹³² *Id.*

¹³³ J. WILLIAM HICKS, 7 EXEMPTED TRANSACTIONS UNDER SECURITIES ACT 1933 § 6:130 (2007) (comparing the costs of Regulation A offerings to public offerings).

¹³⁴ “The purpose of the Sarbanes-Oxley Act, ‘as reported by Congress, [wa]s ‘to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility.’” Ginger Carroll, *Thanking Small: Adjusting Regulatory Burdens Incurred By Small Public Companies Seeking to Comply With the Sarbanes-Oxley Act*, 58 ALA. L. REV. 443, 443–44 (2006).

¹³⁵ *Id.*

C. The Effects of Special Investment Privileges

Currently, over 90 percent of private placements are placed with institutional investors.¹³⁶ When the SEC set forth a definition for accredited investors in 1982, institutional investors made up a much smaller percentage of overall investors—roughly 35 percent.¹³⁷ Because institutional investors account for a majority of transactions in the market, the private placement exemption operates to exclude retail investors from taking advantage of investment opportunities available in most transactions that take place today.

One of the reasons why institutional investors currently dominate the market may be because in the past few decades, institutional investors—such as mutual funds—had a regulatory advantage: the 1933 Act “allows issuers, in certain limited circumstances, to issue securities that will be traded only among qualified institutional buyers without having to fully register the securities.”¹³⁸ Thus, because issuers could avoid the full costs of securities registration, they were able to raise capital through mutual funds or other similar institutions more cheaply than through the public market.¹³⁹

Furthermore, according to a study of firms that issue bonds, firms that switch between private issuances and public issuances are larger and tend to have higher credit ratings than firms that only borrow from the public.¹⁴⁰ A larger company with a higher credit rating is likely more stable and thus a more reliable investment than a smaller company with a lower credit rating.¹⁴¹ As a result, companies that issue both private and public securities are expected to constitute more reliable investments for all investors.¹⁴²

¹³⁶ See Markham, *supra* note 4, at 347–49.

¹³⁷ *Id.*

¹³⁸ Shimon B. Edelstein, *Indexing Capital Gains for Inflation: The Impacts of Recent Inflation Trends, Mutual Fund Financial Intermediation, and Information Technology*, 65 BROOK. L. REV. 783, 811 (1999).

¹³⁹ *Id.*

¹⁴⁰ Simon H. Kwan & Willard T. Carleton, *Financial Contracting and the Choice Between Private Placement and Publicly Offered Bonds* (Fed. Reserve Bank of San Francisco, Working Paper No. 2004-20), available at <http://www.frbsf.org/publications/economics/papers/2004/wp04-20bk.pdf>.

¹⁴¹ See Ethiopis Tafara, *Global Capital Markets and the U.S. Securities Laws 2009: Strategies for the Changing Regulatory Environment*, 1743 PLI/CORP. 1111, 1123 (2009).

¹⁴² *See id.*

Because issuers can raise money more cheaply by going to institutional investors by using private issuances, it likely creates an uneven playing field where institutional investors have an advantage over retail investors.¹⁴³ Thus, it is no surprise that some expect retail investors to become extinct in the near future, leaving a market composed of just institutional investors.¹⁴⁴ After all, why would an issuer choose to spend more money to bring an issuance to the public market when they could spend less and bring it to an institutional investor?

Consequently, if individual investors wish to take advantage of private placement investment opportunities and have the discretionary income to risk, there is no compelling reason for the government to bar them from participating in these types of investment opportunities. This is particularly true in light of the fact that investment risk and investment return are inherently linked together.¹⁴⁵ Usually, the higher risk investments have a correlating higher potential for return on that investment.¹⁴⁶

D. Current Financial State

The current financial state of Americans is bleak; therefore, it may make sense to offer retail investors better opportunities to generate higher returns with their discretionary income.

U.S. savings rates have decreased over the past few decades.¹⁴⁷ In the 1970s, Americans were saving approximately 11 percent of their income.¹⁴⁸ This average savings percentage began to decrease in the 1980s, and by 2005 Americans were saving only 1 percent of their income.¹⁴⁹ After the real estate bubble burst in 2008, the trend reversed, with the annual savings percentage going up to 7

¹⁴³ See *id.* (describing the advantages that mutual funds have over retail investors because issuers can raise money more cheaply by avoiding the full costs of securities registration when issuing securities to mutual funds).

¹⁴⁴ See *supra* text accompanying notes 70–71.

¹⁴⁵ *Balancing Risk and Return to Meet Your Goals*, *supra* note 5.

¹⁴⁶ See *id.*

¹⁴⁷ David Francis, *How the Savings Rate Could Hobble the Economic Recovery*, U.S. NEWS, Jan. 6, 2012, <http://money.usnews.com/money/business-economy/articles/2012/01/06/how-the-savings-rate-could-hobble-the-economic-recovery> (describing the current U.S. savings rate and how it impairs the U.S.'s economic recovery).

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

percent in late 2008 and 8 percent in the spring of 2009.¹⁵⁰ It may nonetheless be some years before the benefits of savings are realized.

As a consequence of the low savings rates, fewer and fewer Americans are adequately prepared for retirement.¹⁵¹ Recently, some investors experienced a dramatic decline in the value of their 401(k)s that have in some cases depreciated by up to 75 percent.¹⁵² Moreover, many individuals have had to resort to using their 401(k) savings to pay bills they have accrued because of unemployment.¹⁵³ This means that many Americans have not been saving enough to retire comfortably.¹⁵⁴ And, some of those who did save money in their 401(k)s had risky investments and their savings were consumed by the tumultuous stock market.¹⁵⁵

To enjoy a comfortable retirement, an individual will likely need to have saved a minimum of \$1.1 million by the age of sixty-five.¹⁵⁶ Nevertheless, 54 percent of retirees have saved less than \$25,000 for their individual retirements.¹⁵⁷ In addition to having saved a mere fraction of the full cost of retirement, 42 percent of

¹⁵⁰ *Id.*

¹⁵¹ Manny Krantz, *Many Have Little to No Savings as Retirement Looms*, USA TODAY, Dec. 4, 2011, <http://www.usatoday.com/money/perfi/retirement/story/2011-12-02/retirement-not-saving-enough/51642848/1> (describing the gravity of the savings problem in the United States and proposing solutions).

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* As an aside, it seems as though based upon statistics and the lessons gleaned from our most recent financial crisis, that if the country were to regulate what kinds of investments some people can or cannot make, regulators have a stronger argument for using age as a basis of regulation rather than by using the accredited investor standard. Many of these near-retirees who have been most affected by the recent financial crisis are of an age where the risk level in their portfolio may have worked to their detriment. Coincidentally, the only age group that collectively meets the accredited investor standards is the group containing members between the ages of sixty-five and seventy-four. Therefore, as a group, individuals between the ages of sixty-five and seventy-four have access to the riskiest investment vehicles, but conventional wisdom says that as an investor grows older, he or she should bear less and less risk. It may thus make more sense to regulate investment activities on the basis of age than on the basis of an arbitrary income or net-worth standard.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

retirees have debt, which further aggravates the problem.¹⁵⁸ The combination of retirees failing to save enough for retirement and simultaneously possessing debt means that many Americans will have to postpone their retirement.¹⁵⁹ As a result, a growing number of Americans are expecting to work into their seventies, and have no plan in place to pay down their debts.¹⁶⁰

Even worse, the recent decline in property values have added to the financial problem that is still growing today,¹⁶¹ which may explain why the SEC modified the definition of accredited investors to exclude the value of residential homes.¹⁶² The home equity that some homeowners were expecting to use for retirement is no longer available to them because many homeowners suffered huge losses when the value of their home declined precipitously between 2006 and 2011.¹⁶³ Some economists predict that in 2012, American home values will wane once again—falling by another 5 percent.¹⁶⁴ For many homeowners, these homes were their primary investments.

One of the reasons why property values may continue to decline is because there are still excess vacant homes in the marketplace.¹⁶⁵ In fact, the predicted decline in home values does not take into account that there are many houses undergoing the foreclosure process, which have yet to enter the market.¹⁶⁶ Some predict that the housing market will not recover until these vacant homes are off the market.¹⁶⁷ Regardless, because home values have declined to such a great extent over the past few years, there is less home equity available for homeowners to use for retirement.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *See supra* note 20.

¹⁶³ FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 211 (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

¹⁶⁴ David Leonhardt, *Is Another Housing Crash Coming?*, N.Y. TIMES BLOG (May 11, 2011, 9:00 AM), <http://economix.blogs.nytimes.com/tag/mark-zandi/>.

¹⁶⁵ Nin-Hai Tseng, *Housing, Stocks, Gold and Oil: Hot or Not in 2012?*, CNN MONEY.COM, Dec. 28, 2011, <http://money.cnn.com/galleries/2011/fortune/1112/gallery.bull-versu-bear.fortune/3.html>.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

Taken together, most Americans face a grim financial outlook. With decreased savings combined with higher levels of debt and declining home values, the average American faces financial hardship for the foreseeable future. Given the current state of the average American’s finances, it is only reasonable to create better investment opportunities for Americans with discretionary income to promote more efficient capital formation.

V. Conclusion and Recommendation

The criteria for evaluating whether a particular investor can afford to take risks should be based on whether the investor has discretionary income, not on whether he or she is worth an arbitrary amount of money, or makes some arbitrary amount of income. An individual’s wealth is not necessarily indicative of his or her level of financial sophistication, and yet wealthy individuals meeting the accredited investor standard are allowed to make riskier investments because it allows for better capital formation.

If an individual possesses the freedom to waste the entirety of his or her discretionary income on completely inessential goods and services or even give or gamble it away, why should the government bar the same individual from using his or her discretionary income to invest toward retirement, regardless of the level of risk? Affording an individual with discretionary income the freedom to invest as he or she chooses would benefit society because it would facilitate better capital formation—which is precisely the reason why unsophisticated wealthy individuals qualify as accredited investors.

Few investors qualify to invest in private placements as accredited investors, yet it benefits issuers to issue securities as private placements because, *inter alia*, it is cost effective and confidential. Therefore, the investors who are eligible to invest in private placements are able to take advantage of an exclusive investment opportunity, which may be a reason why institutional investors currently dominate the trading market.

Historically, institutional investors have grown rapidly and are taking up an increasingly larger proportion of the trading market. If institutional investors continue to saturate the trading market and retail investors become an increasing minority, then eventually there is a risk that the trading market may lose its retail investors. With a smaller supply of potential investors, and a steady corporate demand for capital, the cost of capital may rise, resulting in less effective capital formation.

Moreover, because issuers can save money in securities registration costs by avoiding a public issuance, issuers are more likely to want to attract investors in private issuances by offering better terms. With most Americans suffering financially in the wake of a countrywide financial crisis and a recent track record of Americans inadequately preparing for retirement, it makes sense to allow investors more freedom to invest their discretionary income in whatever manner they choose.

The private placement exemption may primarily benefit those who are already wealthy by affording them better investment opportunities to the exclusion of retail investors in the U.S. A potential problem is that because the private placement exemption allows issuers a more cost-effective means of raising capital, issuers may prefer to use private placements rather than dealing with the regulatory rigmarole associated with pursuing costlier public issuances.

Currently, there are no available studies tracking the performance of institutional investors to determine whether there is a statistically significant correlation between the variance in investment returns as measured by Jensen's Alpha¹⁶⁸ and the growing ratio of institutional investors to individual investors in the marketplace. There is a pressing need for such studies that would cover the time period spanning from 1980 to 2010 and track equity investment returns in excess of the amount appropriate for the risks undertaken as the ratio of institutional investors grew in proportion to individual investors. Should future research reveal that there is a statistically significant correlation between a decrease in the variance of Jensen's Alpha measures and the ratio of institutional investors in the marketplace, this may suggest that it is more difficult for winning institutional investors to generate abnormal returns when faced with increasing competition from other institutional investors; in other words, institutional investors may be able to generate better abnormal returns when competing against individual investors, which could imply that they have superior information or opportunities. Alternatively, should future research find no statistically significant

¹⁶⁸ Jensen's Alpha is "the difference between a series' realized or expected rate of return and its expected position on the security market line given its risk level." *Jensen's Alpha*, *EnCorr/Portfolio Strategist Knowledge Base*, MORNINGSTAR, <http://datalab.morningstar.com/knowledgebase/asp/Article.aspx?ID=268> (last visited Apr. 5, 2012).

correlation, this could indicate that winning institutional investors are able to generate similar abnormal returns against other institutional investors as they were against individual investors, meaning that individual investors perform similarly to many institutional investors.

Many of the restrictions that are currently placed on retail investors are predicated on the anecdotal premise that individual investors are unable to fend for themselves—but in the absence of any empirical evidence in that regard. Future research ought to focus on quantitatively measuring the performance of institutional investors against other sophisticated investors to help determine whether retail investors really do lack sophistication.