Wealth and Knowledge: Strengthening the Economy by Expanding the Qualified Purchaser "Sophisticated" Standard Under the Investment Company Act of 1940

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ABSTRACT: This Note traces the government's effort to balance the need for investments with the need for regulating the economy. Regulations of the financial industry, largely in response to economic crises such as the Great Depression and the 2008 recession, have focused on limiting investments deemed too risky for the general public to "sophisticated" investors. Struggling to define "sophisticated," Congress and the SEC opted for criteria based on the investor's net worth with narrow exceptions for highly knowledgeable but lower-net-worth individuals. Recent legislation and interpretation of that legislation have expanded these narrow exceptions, suggesting the trend is moving towards investor eligibility criteria based on sophistication measures beyond net-worth. This change is a positive one for investors, businesses, and the economy as a whole. However, the benefits of the current efforts to expand the definition of "sophisticated" cannot be realized because legislative incentives for investment managers continue to limit investment opportunities to only the very rich without regard for knowledge or expertise. This Note proposes that Congress should expand the Qualified Purchaser standard under the Investment Company Act of 1940 to allow sophisticated but lower-net-worth individuals to invest in hedge funds.

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I. INTRODUCTION

Fear surrounding economic downturns is not a recent phenomenon. After the stock market crash, or "Black Tuesday," that propelled the United States into the Great Depression in 1929, *The New York Times* reported, "[s]tock prices virtually collapsed yesterday," and called the crash "the most disastrous in Wall Street's history."[1] Almost 79 years later, in 2008, a headline in *The New York Times* proclaimed, "For Stocks, Worst Single-Day Drop in Two Decades."[2] As is typical in moments of fear and panic, the American public searched for answers that might explain the losses that left many without jobs or opportunities. The American government, seeking to alleviate such fears,

1. *Stocks Collapse in 16,410,030-Share Day, but Rally at Close Cheers Brokers; Bankers Optimistic, to Continue Aid*, N.Y. TIMES: ON THIS DAY (Oct. 29, 1999), http://www.nytimes.com/learning/general/onthisday/991029onthisday_big.html (last visited Oct. 12, 2016).

2. Vikas Bajaj & Michael M. Grynbaum, *For Stocks, Worst Single-Day Drop in Two Decades*, N.Y. TIMES (Sept. 29, 2008), http://www.nytimes.com/2008/09/30/business/30markets.html.

implemented measures to regulate the financial industry and reinstill the public with faith in the economy.[3]

Both the Great Depression and the 2008 crash were largely the result of speculation and unsound investment advice, leaving much of the general public blindsided by severe losses.[4] The government reacted by regulating certain investments deemed too risky for the general public and limited those who could invest to only the "sophisticated."[5] Congress and the Securities and Exchange Commission ("SEC") decided that hedge funds—greatly leveraged, high-risk, high-reward investment opportunities available to only the very rich that are subject to minimal regulations[6]—were too risky for the average investor.[7] Only "sophisticated investors," reasoned the government, are able to appreciate the risk involved and can more freely invest in hedge funds. As a proxy for "sophistication," an individual was "sophisticated" if she was wealthy—an Accredited Investor[8] or Qualified Purchaser,[9] depending on the type of hedge fund.

The government and the public largely blamed hedge funds for the 2008 collapse.[10] Even before the crash, there was significant criticism surrounding

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3. *See* JOSEPH WILLIAM SINGER, NO FREEDOM WITHOUT REGULATION: THE HIDDEN LESSON OF THE SUBPRIME CRISIS 59 (2015) (describing the need for regulations following the financial crisis in 2008 as driven by the lessons "that people can be fooled into taking on financial burdens that they cannot bear and that these arrangements have the potential to undermine economic prosperity for all of us[,] . . . that when we begin to gamble on the infrastructure of economic life, we pose undue risks to ourselves and our neighbors[,] [a]nd . . . that markets will better reflect our preferences if we enact laws that ensure that we get what we bargain for").

4. *See* Steve Denning, *Lest We Forget: Why We Had a Financial Crisis*, FORBES (Nov. 22, 2011, 11:28 AM), http://www.forbes.com/sites/stevedenning/2011/11/22/5086 (describing role of subprime mortgages in the financial crisis as advertised and sold to consumers as high-yield investments without disclosure of risks, which allowed mortgage originators to bundle mortgages and "relax underwriting standards, abdicating traditional lending metrics such as income, credit rating, debt-service history and loan-to-value[,]" which led to huge defaults in mortgages and ultimately an economic collapse).

5. *See infra* Part II.B.

6. U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf (describing hedge funds as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act").

7. The regulations following the Great Depression did not specifically target hedge funds, because the first hedge fund did not appear until 1949. However, the regulations following both the crash of 1929 and 2008 sought to address the highly speculative, leveraged, and overall risky investment strategies that led to severe losses. *See* James E. McWhinney, *A Brief History of the Hedge Fund*, INVESTOPEDIA, http://www.investopedia.com/articles/mutualfund/05/hedgefundhist.asp (last visited Oct. 12, 2016).

8. *See infra* Part II.B.1.

9. *See infra* Part II.B.2.

10. *See Hedge Funds Took a Serious Hit in 2008*, CBS NEWS (Jan. 12, 2009, 7:14 PM), http://www.cbsnews.com/news/hedge-funds-took-a-serious-hit-in-2008 (describing the hedge fund industry as characterized by greed and overconfidence and "[u]sing sophisticated trading models," promising to make "wealthy people wealthier with eye-popping returns that carried seemingly

hedge funds, leading one famous hedge fund manager, Mario Gabelli, to write in 2000: "[M]ost folks would characterize [a hedge fund] as a highly speculative vehicle for unwitting fat cats and careless financial institutions to lose their shirts."[11] However, the bad rap hedge funds have endured is misplaced,[12] as hedge funds are not actually as risky as the post-2008 headlines would lead the public to believe.[13] Rather, hedge funds provide benefits to the investor that an ordinary mutual fund or stock investment cannot—they allow diversification in an investor's portfolio[14], which provides a safeguard against risk, and they provide absolute returns,[15] allowing the investor a better chance to profit.[16] Both Congress and the SEC seem to recognize that the risks of hedge funds have been overstated as they have recently expanded access to hedge funds to knowledgeable but lower-net-worth individuals.[17] Investments are necessary for the success of an economy, and placing severe limits on access to that market risks harming small business. This is especially true because private, small businesses make up the bulk of most hedge fund portfolios.[18]

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moderate risk" before being "[b]lind-sided" by their failure and the market collapse); Ben Rooney, *Hedge Fund Graveyard: 693 and Counting*, CNN MONEY (Dec. 18, 2008, 5:14 PM), http://money.cnn.com/2008/12/18/news/economy/hedge_fund_liquidations ("A record number of hedge funds went bust . . . as shaky markets and tight credit drove investors away from risky investments.").

11. Mario J. Gabelli, *The History of Hedge Funds—The Millionaire's Club* (Oct. 25, 2000), http://www.gabelli.com/news/mario-hedge_102500.html; *see also* GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 31 (2009) (quoting Felix Rohatyn, a former investor banker at Lazard Frères, who referred to derivatives, a primary strategy of hedge funds, as "financial hydrogen bombs, built on personal computers by twenty-six-year olds with MBAs").

12. As Mario Gabelli, the hedge fund manager quoted previously, stated: "You will have to look beyond the recent headlines that have given hedge funds a bad name and realize that hedge funds are as good or bad as the folks that are operating them." Gabelli, *supra* note 11.

13. Steven M. Davidoff, *To Reduce Hedge Fund Risk, Let Everyone In*, N.Y. TIMES (Sept. 16, 2009), http://www.nytimes.com/2009/09/17/business/17HEDGE.html.

14. *Id.*; *see also Diversification*, INVESTOPEDIA, http://www.investopedia.com/terms/d/diversification.asp (last visited Oct. 13, 2016) ("Diversification is a risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio constructed of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio.").

15. A hedge fund is an absolute return fund, which means that it "seeks to make positive returns," unlike a mutual fund, a type of relative return fund that merely "seeks to produce returns that are better th[an] its peers, its fund category, and the market as a whole." *Absolute Return*, INVESTOPEDIA, http://www.investopedia.com/terms/a/absolutereturn.asp (last visited Oct. 13, 2016).

16. Davidoff, *supra* note 13 (arguing that the fear of hedge funds is unwarranted because hedge funds provide valuable strategies for investors and are not actually as risky as many believe because "[t]hey live up to their name: they (ideally) hedge their returns so that they are less volatile," and further arguing that access to hedge funds should be expanded as "an important part of the diversified investment portfolio that financial experts recommend").

17. *See infra* Part II.C.

18. *See infra* Part III.C.

When regulating the financial industry, the government must weigh its need to boost the economy by allowing greater public access to investments against the need to ensure investors cannot take excessive risks, which could harm the economy as a whole by leaving investors unwilling and often unable to invest.[19] This Note argues Congress and the SEC should continue to expand access to hedge funds, which would benefit the entire economy because these investors could contribute both their capital and expertise to growing businesses. Part II offers a description of the regulatory framework for hedge funds and how the framework has expanded to allow more of the public to access investment opportunities. Part III discusses problems with the current framework, particularly regarding the failure of the current regulatory framework to define who is "sophisticated" enough to invest. Part IV proposes a range of solutions, from a long-term solution of measuring financial literacy to amending the 1940 Act to expand the Knowledgeable Employee Rule, as well as encouraging the SEC to take selective enforcement measures by issuing No-Action Letters.

II. HEDGE FUNDS: A REGULATORY FRAMEWORK

When it comes to the economy and the financial industry, the government has at least two interests at play: the need for protection and the need for growth.[20] For the economy to grow, the government must ensure that the public has faith in the financial industry and continues to invest.[21] As a result, the regulatory landscape of the financial industry fluctuates between periods of economic prosperity and recessions, which are quickly followed by regulations to encourage the public to invest again.[22] These regulations, if successful, restore consumers' willingness to invest, a necessary precondition for a revitalized economy.[23] However, these regulations limit the public's

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19. *See infra* Part II.

20. In fact, the SEC, the agency charged with regulating the financial industry, has said that regulation is necessary to ensure a strong economy because "[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions." *What We Do*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last updated June 10, 2013). "The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy." *Id.*

21. *See* SINGER, *supra* note 3, at 59 (arguing that regulations preserve freedom and stimulate the economy because "[f]ar from interfering in the free market or undermining economic efficiency, consumer protection law is a cornerstone of well-functioning markets[:] . . . promot[ing] freedom of contract and social welfare and . . . protect[ing] property rights").

22. *See Timeline*, SEC. & EXCH. COMM'N HIST. SOC'Y, http://www.sechistorical.org/museum/timeline (last visited Oct. 13, 2016) (tracing the history of U.S. and world events and subsequent SEC regulation of the financial industry).

23. *See* SINGER, *supra* note 3, at 59 (describing the need for and benefits of regulations following the financial crisis in 2008 as driven by the lessons "that people can be fooled into taking on financial burdens that they cannot bear and that these arrangements have the potential to undermine economic prosperity for all of us[,] . . . that when we begin to gamble on the infrastructure of economic life, we pose undue risks to ourselves and our neighbors[,] [a]nd . . .

access to certain investment opportunities, which may prevent the economy from quickly recovering from economic downturns.

Hedge funds, while a nebulous concept, are characterized primarily as being relatively free from regulations,[24] especially when compared to their heavily regulated counterpart, mutual funds.[25] The lack of hedge fund regulation is due to their ability to meet exemptions under laws regulating the investment industry: the Securities Act of 1933 ("1933 Act"),[26] the Securities Act of 1934 ("1934 Act"),[27] the Investment Company Act of 1940 ("1940 Act"),[28] and now the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd–Frank").[29] From the perspective of an investment manager, ideally, the fund would be exempt from all four Acts, thus avoiding regulations in the form of registration, disclosures, and overall lack of flexibility in investment strategy.[30]

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that markets will better reflect our preferences if we enact laws that ensure that we get what we bargain for").

24. Erik J. Greupner, Comment, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1558–59 (2003) (acknowledging "[t]here is no statutory definition for the term 'hedge fund,'" but "defin[ing] hedge funds as privately offered, relatively unregulated pooled investment vehicles . . . that have the flexibility to invest in a broad range of securities and commodities using a broad range of trading techniques"); *see also* Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 243 (2009) ("A hedge fund is a private investment company that is not subject to the full range of restrictions on investment activities and disclosure obligations imposed by federal securities laws, that compensates management in part with a fee based on annual profits, and typically engages in the active trading of financial instruments.").

25. A mutual fund refers to "an investment vehicle [that is] made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, [etc.]" that is "professionally managed," and typically available to the public. *See Mutual Fund*, INVESTOPEDIA, http://www.investopedia.com/terms/m/mutualfund.asp (last visited Oct. 16, 2016); *see also* Jasmin Sethi, *Another Role for Securities Regulation: Expanding Investor Opportunity*, 16 FORDHAM J. CORP. & FIN. L. 783, 812 (2011) (describing "daunting disclosure requirements" of mutual funds, such as "all costs, fees, and charges" and "the fund's investment objective and investment policies" among others); *Fast Answers: The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml (last updated Oct. 1, 2013) (describing reporting and registration requirements of publicly traded companies and companies that invest in public companies, such as mutual funds).

26. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a–77aa (2012)).

27. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

28. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80a (2012)).

29. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

30. *See generally* 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION (providing an overview of federal laws governing securities regulation); Sargon Daniel, Note, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 258–64 (2007) (discussing the regulatory effects of the 1933 Act, 1934 Act, and 1940 Act on hedge funds).

This Part traces the regulatory framework governing the financial industry. While Congress and the SEC continue to heavily regulate the financial industry, there is a trend towards allowing greater access to investments. Part II.A discusses regulatory efforts in response to economic downturns and recessions. Part II.B analyzes the current regulatory approach to investor eligibility, and Part II.C illustrates efforts to expand investor eligibility to include measures of sophistication beyond net-worth thresholds.

A. Economic Downturns and Subsequent Regulations

The federal government has heavily regulated the financial industry since the New Deal era, following the stock market crash of 1929.[31] While a strong and largely unregulated post-war economy marked the "booming twenties" era,[32] the 1929 crash led to a sharp decline in the economy, and the public became increasingly wary of investments.[33] While the crash inevitably affected investment banks, the banks remained relatively unscathed in comparison to the average American, and the banks were unsympathetic characters since their highly leveraged and risky schemes were a significant reason for the crash.[34] Following the crash, there was an immediate call for increased regulation of the investment industry, and the government responded.[35]

Following the Great Depression, the government quickly reacted by enacting legislation regulating the financial industry,[36] such as the 1933 Act, the 1934 Act, the 1940 Act, and The Investment Advisers Act of 1940.[37] The 1933 Act and the 1940 Act limit access to certain investments deemed too

31. *See* Daniel, *supra* note 30, at 276–77 (describing the effect of the Great Depression on the economy and the government's reaction, under the leadership of President Roosevelt—regulation of the financial industry).

32. *Id.* at 275–76.

33. *The Great Depression*, HISTORY, http://www.history.com/topics/great-depression (last visited Oct. 16, 2016) ("[T]he stock market crash of October 1929 . . . sent Wall Street into a panic and wiped out millions of investors. Over the next several years, consumer spending and investment dropped, causing steep declines in industrial output and rising levels of unemployment as failing companies laid off workers.").

34. *See* Daniel, *supra* note 30, at 276–77. The distrust of the banking industry following the Great Depression led to the enactment of the Glass–Steagall Act in 1933, which was designed to restore public confidence in the banking industry by requiring the separation of investment and commercial banks. This Act is outside the scope of this Note, which focuses on federal laws specific to investing in securities. For a history of the Glass–Steagall Act, see Reem Heakal, *What Was the Glass-Steagall Act?*, INVESTOPEDIA, http://www.investopedia.com/articles/03/071603.asp (last updated Nov. 16, 2015, 6:37 PM).

35. *See* Daniel, *supra* note 30, at 275–76 (describing the political and economic conditions preceding increased governmental regulation of mutual funds).

36. *Securities and Exchange Commission*, HISTORY, http://www.history.com/topics/securities-and-exchange-commission (last visited Oct. 16, 2016).

37. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2012); *see also Fast Answers: The Laws that Govern the Securities Industry*, *supra* note 25 (describing the purpose and focus of each law).

risky for the average public.[38] The 1933 Act is known as the "truth in securities" law and governs publicly offered securities, requiring disclosure to "prohibit deceit, misrepresentations, and other fraud in the sale of securities."[39] The 1934 Act created the SEC, whose proclaimed mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[40] The 1940 Act, like the 1933 Act, requires disclosure, but focuses on regulating companies in the business of investing, rather than the individual securities themselves.[41]

The overarching policy of these regulations is disclosure, where companies offering securities to the public are required to disclose information that would affect an individual's decision of whether to invest.[42] However, Congress and the SEC have decided that some investment strategies, namely hedge funds, are so risky that disclosure alone is insufficient to protect investors. For these strategies, the 1933 Act and 1940 Act instead focused on limiting the type of investor who could access risky investment opportunities to only those investors who are "sophisticated."

B. Investor Eligibility: Defining "Sophisticated"

Within these regulations limiting investor eligibility, Congress and the SEC have since carved out exceptions for certain "sophisticated investors" who may invest in hedge funds without subjecting that fund to regulations under the federal securities laws. In keeping with the policy of protecting the public from risky investments, being a "sophisticated" investor requires an ability to appreciate risks. In an effort to create a bright-line rule, the SEC and Congress have determined that an investor is "sophisticated" if she meets specified income and net-worth benchmarks.[43] Thus, a hedge fund manager wishing to acquire investors without being subject to the regulations of the federal securities laws can only allow high-net-worth individuals to invest.[44] These high-net-worth investors are called Accredited Investors or Qualified Purchasers, depending on the type of hedge fund.[45] Qualified Purchasers are subject to a higher-net-worth requirement because they are eligible for investments deemed too risky for even the Accredited Investor.[46] However, current statutes and regulations have acknowledged that an individual with

38. *See Fast Answers: The Laws that Govern the Securities Industry*, *supra* note 25.

39. *Id.*

40. *What We Do*, *supra* note 20.

41. *Fast Answers: The Laws that Govern the Securities Industry*, *supra* note 25.

42. *See id.*

43. Greupner, *supra* note 24, at 1588 ("Net worth as a proxy for sophistication is the common thread of policy that runs through congressional action and SEC regulation concerning which individuals do not need the protections of federal securities regulation.").

44. *See infra* Part II.B.

45. *See infra* Part II.B.

46. *See infra* Part II.B.2.

knowledge of the financial industry but without a high net worth may also be "sophisticated."[47] Thus, the regulations have allowed limited exceptions for these lower-net-worth yet highly knowledgeable investors.

1. Accredited Investor Standard

The 1933 Act regulates public companies that seek investors and are listed on a national exchange by requiring registration and reporting.[48] The purpose of the 1933 Act is to prevent "deceit, misrepresentations, and other fraud in the sale of securities."[49] Thus, the policy of the 1933 Act emphasizes disclosure to ensure the public has access to accurate information that would affect the decision of whether to invest.[50] The disclosure requirements, including a registration statement and continuous reporting, apply to individual securities that are listed on a national exchange and available for sale to the general public.[51] However, certain securities are exempt from registration, including private offerings limited to only certain high-net-worth individuals.[52] These investors are known as "Accredited Investors," defined as individuals with a net worth of at least $1 million or an annual income over $200,000 (or $300,000 together with a spouse).[53] The purpose of providing an exception for smaller, private offerings is to "foster capital formation by lowering the cost of offering securities to the public,"[54] while ensuring that those who may invest understand the risks associated with such investments.

The Dodd–Frank Act[55] placed further restrictions on what it means to be an Accredited Investor. The law espoused a policy of protecting investors[56]

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47. *See infra* Part II.C.

48. See *Fast Answers: Registration Under the Securities Act of 1933*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/regis33.htm (last updated Sept. 2, 2011).

49. *Fast Answers: The Laws That Govern the Securities Industry*, *supra* note 25.

50. The 1934 Act shares the 1933 Act's policy of disclosure. While there is overlap between the purpose of the 1933 and 1934 Act, the 1934 Act applies mostly to the national exchanges while the 1933 Act regulates the investment opportunities listed on those exchanges. The 1933 Act is more relevant to this Note because it outlines eligibility criteria investors must meet. For purposes of this Note, the primary relevance of the 1934 Act is that it created the SEC, which is responsible for regulating securities and investments. *See id.*

51. *Fast Answers: Registration Under the Securities Act of 1933*, *supra* note 48.

52. *Id.*

53. An "Accredited Investor," in the context of natural persons, must either (1) have had an income of $200,000 per year, or $300,000 per year with a spouse, for the past two years; or (2) have a net worth of $1 million individually or jointly with a spouse. *See* 17 C.F.R. § 230.501 (5)–(6) (2016). Although banks, businesses, and organizations may also qualify as Accredited Investors, this Note will focus on natural persons who may qualify.

54. *Fast Answers: The Laws That Govern the Securities Industry*, *supra* note 25.

55. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

56. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/dodd-frank.shtml (last updated July 7, 2016) ("The overarching objective of [SEC rulemaking pursuant to Dodd–Frank] is to promote the long-term sustainability of the U.S. financial system. While the worst of the financial crisis is

and was signed into law July 21, 2010.[57] The Dodd–Frank Act, which is still in the process of being implemented through rulemaking efforts by the SEC, seeks to remedy the 2008 collapse that was caused by risky, highly leveraged investing strategies that were largely unregulated and not backed by adequate capital, such as hedge funds[58] and mortgage-backed securities.[59] Because of the housing crisis, the Dodd–Frank Act does not allow individuals to claim the value of their home when calculating the net worth, thus narrowing the definition of Accredited Investor.[60] After all, the ease with which people could obtain mortgages in the 2000s meant that the value of a person's home was in no way a measure of the individual's ability to adequately assess risk.

2. Qualified Purchaser Standard

Like the 1933 Act, the 1940 Act exists to protect investors by requiring disclosures[61] and limiting certain investments to only "sophisticated" high-net-worth investors[62] called Qualified Purchasers. Under section 3(c)(7) of the

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behind us, the Commission intensively continues its critical work to fulfill our obligation to protect investors, enhance market stability, and promote capital formation.").

57. Jesse Lee, *President Obama Signs Wall Street Reform: "No Easy Task"*, WHITE HOUSE (July 21, 2010, 2:22 PM), https://www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task.

58. *See* Daniel, *supra* note 30, at 264 (discussing hedge funds exemptions from regulation and the flexibility that such funds enjoy, allowing "changing the classification of the fund, borrowing money, issuing or underwriting securities, and changing its concentration of investments" (footnotes omitted)). *But see* Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REG. MAG., Spring 2007, 36, 39, http://object.cato.org/sites/cato.org/files/serials/files/regulation/2007/3/v30n1-1.pdf (arguing "[s]ystemic risk is hardly unique to hedge funds . . . . All financial institutions carry a degree of this risk," and suggesting that "[t]he question for policymakers is whether hedge funds' systemic risk is socially undesirable and remediable by lawmaking").

59. *See* Denning, *supra* note 4.

60. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act § 413; Sethi, *supra* note 25, at 802 ("Congress directed the SEC to exclude the value of an individual's primary residence when computing the individual's net worth . . . fewer individuals, as a result, can satisfactorily meet the conditions necessary for becoming accredited investors.").

61. Comment, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 445–46 (1941) ("[T]he registration of an investment company will require about the same type of disclosure as the [1933 Act] and the [1934 Act] . . . . All of these disclosure provisions are designed . . . to safeguard the potential purchaser of investment securities [and] the individual who is already a stockholder."); *see also* CITI PRIME FIN., INTRODUCTION AND OVERVIEW OF 40 ACT LIQUID ALTERNATIVE FUNDS 5 (2013), https://www.managedfunds.org/wp-content/uploads/2013/09/Citi-40-Act-Funds-White-Paper-July-2013-2.pdf; *Fast Answers: The Laws that Govern the Securities Industry*, *supra* note 25 ("The focus of [the 1940 Act] is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.").

62. The provision of the 1940 Act that sets the criteria for sophisticated, high-net-worth investors was added in 1997. Greg Oguss, Note, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285, 296 (2012) ("In response to worries that the § 3(c)(1) exemption for investment companies with 100 U.S. investors or less was overly restrictive, the SEC . . . proposed an exemption for companies that sold solely securities only to 'qualified

1940 Act, funds do not need to register if investors are limited to Qualified Purchasers—individuals with at least $5,000,000 in liquid assets.[63] While the 1933 Act regulates the individual securities listed on a national exchange, the 1940 Act regulates the companies that package those individual securities, typically as mutual funds, and sell to investors.[64] Specifically, the 1940 Act regulates Investment Companies, defined as entities primarily in the business of investing and managing those investments for its investors or shareholders.[65] As a result of such regulations, investors who may not understand the intricacies of the fund structures and do not want to bear significant risks are protected through government regulation and required disclosures of the funds.[66]

Hedge funds are exempt from registration under the 1940 Act[67] because the registration requirements apply primarily to companies that offer public securities packaged into vehicles like mutual funds to the general public, and do not include companies that offer private investments.[68] The 1940 Act-exempt funds are afforded greater flexibility in strategy and the amount of leverage they may employ than their 1933 Act-exempt counterparts.[69]

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purchasers' considered sufficiently sophisticated based on wealth . . . to not require statutory protection.").

63. "Qualified Purchaser" is defined as a person, company, or trust meeting one of four requirements: (1) "any natural person . . . who owns not less than $5,000,000 in investments"; (2) family companies "that own[] not less than $5,000,000 in investments and that [are] owned directly or indirectly by or for 2 or more natural persons"; (3) "any trust . . . that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a [natural person or company]"; or (4) "any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments." 15 U.S.C. § 80a-2(a)(51) (2012). This Note will focus on Qualified Purchasers as natural persons owning at least $5,000,000 in investments.

64. *See* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)); Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80a-1 to 80a-64 (2012)).

65. 15 U.S.C. § 80a-3(a)(1) (2012); David J. Oliveiri, *What Is an "Investment Company" Under § 3 of Investment Company Act of 1940 (15 U.S.C.A. § 80a-3)*, 64 A.L.R. FED. 337, § 2[a] (1983).

66. *Id.*

67. *See* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 783 (2004). The National Securities Markets Improvement Act of 1996 gave the SEC authority to issue rules and regulations regarding who could invest in hedge funds. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.); *see also* Kevin A. Jones, *The National Securities Markets Improvement Act of 1996: A New Model for Efficient Capital Formation*, 53 ARK. L. REV. 153, 154–55 (2000) (describing the 1996 Act as "an attempt to promote efficiency, competition, and capital formation in the capital markets by reducing the number of overlapping state and federal securities regulations").

68. *Fast Answers: The Laws That Govern the Securities Industry*, *supra* note 25.

69. *See* CITI PRIME FIN., *supra* note 61, at 6 (describing restrictions placed on the strategies of mutual funds, or non-1940-Act-exempt funds, including: (1) "[m]aintain[ing] 85% of their portfolio in liquid assets and hold[ing] no more than 15% of their assets in illiquid securities";

Because this greater flexibility and leverage is associated with greater risk, the 1940 Act imposes more stringent net-worth requirements for investors deemed "sophisticated" enough to participate.[70]

C. EXPANDING "SOPHISTICATED"

When determining whether an individual may participate in investment strategies that are exempt from the federal securities laws, net-worth requirements have acted as a proxy for "sophisticated."[71] However, Congress has enacted legislation expanding "sophisticated" to include lower-net-worth individuals who are highly knowledgeable about finance and investing to invest in hedge funds. As a general rule, the ability to invest in a hedge fund is conditioned on an individual's ability to appreciate risk associated with these investments. Presumably, these individuals are not in need of the government protection available in other investment options, such as mutual funds.[72]

In 1953, the Supreme Court first suggested that an investor could be "sophisticated" for purposes of the securities laws regardless of the individual's net worth. In this leading case on private offerings under the 1933 Act, *SEC v. Ralston Purina Co.*, the Court determined that exemption from the Securities Act "should turn on whether the" investors "need the protection of the act" or are instead "able to fend for themselves" and appreciate the risks involved.[73] Thus, while the level of the investors' sophistication is largely determined by their net worth, it is clear that the net-worth requirements are in place only to ensure that investors are "sophisticated" and do not need the protection of the Act. In furtherance of this policy, the government has expanded the Qualified Purchaser standard through the Knowledgeable Employee Rule, and the Accredited Investor standard through the Jumpstart Our Business Startups ("JOBS") Act.

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(2) "[c]over[ing] the full value of liabilities created by any use of short sales by holding an equivalent amount of collateral"; and (3) "[l]imit[ing] any use of leverage in their portfolio to 33% of the gross asset value of the fund . . . .").

70. Thus, this Note will focus on exemptions under the 1940 Act, while using the 1933 Act and 1934 Act to illustrate parallel proposals for treating sophisticated investors as Accredited Investors, regardless of net worth. However, this Note argues that changing the Accredited Investor definition would be inadequate when companies would have no incentive to accept those individuals as investors. For a more complete discussion of hedge fund exemptions under the 1933 and 1934 Acts, see Daniel, *supra* note 30, at 257–60.

71. Greupner, *supra* note 24.

72. *See* Sethi, *supra* note 25, at 802 (suggesting "[t]he rationale for denial of access to hedge funds appears to be the desire to isolate the realm in which complex financial institutions, which are difficult to regulate, can cause harm," and therefore limiting these investments to only high-net-worth individuals, such as Accredited Investors or Qualified Purchasers).

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

1. The Knowledgeable Employee Rule and Qualified Purchasers

In 1996, the SEC expanded what it means to be "sophisticated" under the 1940 Act by issuing the Knowledgeable Employee Rule, which allowed individuals to invest if they make investment decisions regarding hedge funds as part of their jobs.[74] This exception is significant because it indicates the government has recognized that individuals with financial literacy and experience may be "sophisticated" enough to invest in a hedge fund, even though they do not meet the net-worth requirements of a Qualified Purchaser or even an Accredited Investor.[75] The exception reflects the government's belief that individuals with a high net worth also have a "high degree of financial sophistication [and] . . . are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the [1940 Act]."[76]

When proposing the Knowledgeable Employee Rule, the SEC requested comments to address "whether the proposed rule should contain any other criteria for identifying knowledgeable employees (*i.e.*, the employee's salary level or the amount of investments owned)," beyond the criteria that qualifying employees must "actively participate in the management of a fund's investments."[77] However, the final rule did not take into account the employee's salary level or amount of investment owned and instead conditioned the employee's knowledgeability on whether she actively participated in the investment decisions of a fund.[78]

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74. A "Knowledgeable Employee" is defined a natural person who is either:

> (i) An Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Covered Company [defined as a company meeting the 3(c)(1) or 3(c)(7) exception] or an [affiliated company]; or (ii) [a]n employee of the Covered Company or an [affiliated company] (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such Covered Company, other Covered Companies, . . . *provided that* such employee has been performing such functions and duties . . . or substantially similar functions or duties . . . for at least 12 months.

17 C.F.R. § 270.3c-5(a)(4)(i)–(ii) (2016).

75. *See* Am. Bar Ass'n Section of Bus. Law, SEC No-Action Letter, 1999 WL 235450 at *6 (Apr. 22, 1999) ("Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with the Section 3(c)(1) Fund or the Section 3(c)(7) Fund, do not need the protection of the Investment Company Act.").

76. Private Investment Companies, 61 Fed. Reg. 68,100, 68,102 (codified at 17 C.F.R. pt. 270) ("These investors are likely to be able to evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption or withdrawal rights.").

77. *Id.* at 68,110.

78. Privately Offered Investment Companies, 62 Fed. Reg. 17,512, 17,524–25 (Apr. 9, 1997).

The SEC has further expanded the Knowledgeable Employee Rule through No-Action Letters, which suggest that net worth is not the sole measure of investor sophistication.[79] The most recent No-Action letter in 2014 indicates employees may invest even if they do not have an executive title, as long as they offer analysis and advice material to investment decisions.[80] For example, research analysts, members of the analytical or risk team, traders, tax professionals, and attorneys could all qualify as knowledgeable employees if their expertise is "material to the investment decisions of a portfolio manager,"[81] even though these employees would not have qualified as knowledgeable employees under the previous 1999 guidance.[82] Although there is a narrow category of individuals who are "financially knowledgeable and sophisticated" enough to invest in unregulated hedge funds, and although that narrow category has been broadened through No-Action Letters, neither the SEC nor Congress has proposed expanding the exception beyond employees of a hedge fund.[83]

2. The JOBS Act and Accredited Investors

The crash of 2008 and ensuing financial crisis created a tension between the need to increase regulations of the financial industry and the need to promote investments to help boost the economy. President Obama acknowledged this tension in his State of the Union address in 2012 and

79. *See* Managed Funds Ass'n, SEC No-Action Letter, 2014 WL 508021, at *14 (Feb. 6, 2014); Am. Bar Ass'n Section of Bus. Law, SEC No-Action Letter, 1999 WL 235450, at *9 (Apr. 22, 1999); *see also* Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 937 (1998) (discussing the role of No-Action Letters, which are defined as letters "in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated" but are not meant to "express any legal conclusion on the questions presented").

80. Managed Funds Ass'n, SEC No-Action Letter, *supra* note 80, at *4. Immediately following the release of the 2014 No-Action letter, many prominent law firms released publications describing the effect of the SEC's interpretation on the Knowledgeable Employee Rule. *See generally, e.g.*, BARRY P. BARBASH ET AL., SEC PROVIDES GUIDANCE REGARDING KNOWLEDGEABLE EMPLOYEES INVESTING IN PRIVATE FUNDS (2014), http://www.willkie.com/~/media/Files/Publications/2014/02/SEC_Provides_Guidance_Regarding_Knowledgeable_Employees_Investing_in_Private_Funds.pdf; DAVIS POLK & WARDWELL LLP, INVESTMENT MANAGEMENT REGULATORY UPDATE (2014), http://www.davispolk.com/sites/default/files/02.24.14.IMG_.Update.pdf; Anastasia T. Rockas & Raymond Z. Ling, *SEC Provides Updated Guidance on 'Knowledgeable Employee' Status Under the Investment Company Act of 1940*, SKADDEN (Feb. 25, 2014), https://www.skadden.com/insights/sec-provides-updated-guidance-knowledgeable-employee-status-under-investment-company-act-1940; Michael L. Sherman et al., *SEC Issues No-Action Letter Expanding Interpretation of the Definition of "Knowledgeable Employee,"* DECHERT LLP (Mar. 2014), https://info.dechert.com/10/3084/march-2014/sec-issues-no-action-letter-expanding-interpretation-of-the-definition-of–knowledgeable-employee-.asp.

81. Sherman et al., *supra* note 81.

82. *See* Am. Bar Ass'n Section of Bus. Law, SEC No-Action Letter, *supra* note 76; Rockas & Ling, *supra* note 81.

83. Managed Funds Ass'n, SEC No-Action Letter, *supra* note 80, at *6.

admonished banks and regulators in 2008 for taking "huge bets and bonuses with other people's money [while regulators] . . . looked the other way."[84] At the same time, he called for "[t]ear[ing] down regulations that prevent aspiring entrepreneurs from getting the financing to grow."[85] Months after this statement, President Obama signed the JOBS Act into law, aiming to grow small businesses and increase jobs by easing regulations that prevented investing in those businesses.[86]

Pursuant to its authority under the JOBS Act, the SEC issued rules on October 30, 2015 expanding access for more people to invest in startup companies.[87] Although only Accredited Investors previously had the opportunity to invest in startup companies, these rules allow an individual who would not meet the net-worth requirements of an Accredited Investor to nonetheless invest in these companies through crowdfunding efforts.[88] The JOBS Act, acknowledging the role of investors in revitalizing the economy, expanded who could contribute to start-ups through crowdfunding efforts on the Internet.[89]

Before this most recent expansion, the SEC had considered expanding the Accredited Investor definition to reflect financial knowledge and

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84. President Barack Obama, Remarks by the President on the State of the Union (Jan. 24, 2012), https://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address.

85. *Id.*

86. *What We Do*, *supra* note 20 ("Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and companies seeking access to capital should not be hindered by unnecessary or overly burdensome regulations."); Steven VanRoekel, *The JOBS Act: Encouraging Startups, Supporting Small Businesses*, WHITE HOUSE: BLOG (Apr. 5, 2012, 4:12 PM), https://www.whitehouse.gov/blog/2012/04/05/jobs-act-encouraging-startups-supporting-small-businesses ("Whether you're in Silicon Valley, Silicon Alley, or Silicon Prairie, this bill is a win-win for small businesses, for the economy, and for the American people.").

87. Sara Ashley O'Brien, *Startup Investing Is No Longer Just for Rich*, CNN MONEY (Oct. 30, 2015, 3:29 PM), http://money.cnn.com/2015/10/30/technology/sec-vote-equity-crowdfunding.

88. Crowdfunding allows small businesses to "raise capital through limited investments from a large number of investors" through the Internet, and the JOBS Act allows the general public, and not only those who meet the requirements to be Accredited Investors or Qualified Purchasers, to invest. *See Crowdfunding and the JOBS Act: What Investors Should Know*, FIN. INDUSTRY REG. AUTH., http://www.finra.org/investors/alerts/crowdfunding-and-jobs-act-what-investors-should-know (last updated May 16, 2016)*; see also Small Business and the SEC: A Guide for Small Businesses on Raising Capital and Complying with the Federal Securities Laws*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/info/smallbus/qasbsec.htm (last updated Feb. 1, 2016) ("Crowdfunding is a means to raise money by attracting relatively small individual contributions from a large number of people.").

89. *See* Chance Barnett, *SEC Democratizes Equity Crowdfunding with JOBS Act Title IV*, FORBES (Mar. 26, 2015, 8:41 PM), http://www.forbes.com/sites/chancebarnett/2015/03/26/infographic-sec-democratizes-equity-crowdfunding-with-jobs-act-title-iv/2 (praising the JOBS Act for allowing non-accredited investors to access start-ups). *But see* Robb Mandelbaum, *Should You Crowdfund Your Next Business?*, INC. (May 2014), http://www.inc.com/magazine/201405/robb-mandelbaum/jobs-act-crowdfunding-problems.html (predicting crowdfunding will "prove far more costly, bureaucratic, and exclusionary" than intended because of the significant disclosure requirements and the difficulty of setting up an online portal).

sophistication. In a 2013 release, the SEC requested comments to consider whether net-worth and income tests were appropriate measures of sophistication, posing the question: "Do such tests indicate whether an investor has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment?"[90] Although the SEC tightened standards on the Accredited Investor status in the Dodd–Frank Act after the housing collapse in 2008 by not considering the value of a person's home when calculating net worth,[91] the SEC has made significant strides under the JOBS Act to expand what it means to be "sophisticated" in the context of investments.

As the Knowledgeable Employee Rule and the crowdfunding exception in the JOBS Act illustrate, the regulatory trend appears to be moving towards greater access to investor opportunity by recognizing that there are measures of sophistication beyond net worth. However, the current regulatory framework continues to suffer from the problems of inadequately capturing what it means to be "sophisticated" and failing to provide incentives for companies to accept lower-net-worth, highly knowledgeable individuals as investors.

III. FAILING TO DEFINE AND IMPLEMENT A WORKABLE DEFINITION OF "SOPHISTICATED"

Congress, the SEC, and the Supreme Court have all been clear that sophistication is the standard to determine whether a person should be able to invest in hedge funds, based on the premise that those investors do not need the government's protection.[92] However, the government has failed to provide an adequate standard for "sophistication," and current regulations continue to incentivize hedge fund managers to accept exclusively high-net-worth individuals. Current legislation provides no incentive to accept the investors that fit within the narrow exceptions carved out in the 1933 Act and 1940 Act for financially sophisticated but lower-net-worth individuals. Instead of providing an adequate definition of what it means to be "sophisticated," Congress and the SEC have taken a short cut by making "high net worth" and "sophisticated" synonymous. Even after expanding the Qualified Purchaser standard to include Knowledgeable Employees, and expanding the Accredited Investor standard to include those participating in crowdfunding

90. Amendments to Regulation D, Form D and Rule 156 Under the Securities Act, Securities Act Release No. 33-9416, 2013 WL 4037787, at *95 (July 10, 2013).

91. *See* Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, 2011 WL 6415435 (Feb. 27, 2012); *SEC Adopts Net Worth Standard for Accredited Investors Under Dodd-Frank Act*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/news/press/2011/2011-274.htm (last updated Dec. 21, 2011); *see also* Paul Sullivan, *Deciding Who's Rich (or Smart) Enough for High-Risk Investments*, N.Y. TIMES: WEALTH MATTERS (Jan. 13, 2012), http://www.nytimes.com/2012/01/14/yourmoney/deciding-whos-rich-or-smart-enough-for-high-risk-investments.html.

92. *See supra* text accompanying notes 74–75.

efforts, the standards remain both too over- and under-inclusive to capture a workable definition of sophistication.

Part III.A argues that while current statutes and regulations acknowledge that an individual may be "sophisticated" without a high net worth, the incentives for a hedge fund to avoid registration and regulation provide no reason to accept these lower-net-worth but highly sophisticated investors. Part III.B suggests that the Knowledgeable Employee Rule and JOBS Act crowdfunding exception help to expand investor eligibility but do not go far enough. Part III.C argues that the inadequacy of current legislative efforts to expand investor eligibility are especially problematic given the effects of 2008 and the federal government's stated interest in helping smaller businesses to revitalize the economy.

A. "Sophisticated": Theory Versus Reality

In theory, those who do not have the high net worth of an Accredited Investor or Qualified Purchaser but are highly knowledgeable about investments and thus do not require the protection of the federal securities laws are still deemed "sophisticated" enough to invest in hedge funds.[93] The government, commentators, and practitioners have all recognized that existing Accredited Investor and Qualified Purchaser standards equating "sophisticated" with high net worth are imperfect measures of sophistication because they are both over- and under-inclusive of this policy.[94] Net-worth criteria are over-inclusive because some qualifying individuals may be extremely wealthy and yet know nothing about investing.[95] Net-worth criteria are also under-inclusive because there are extremely financially sophisticated individuals who do not meet the net-worth requirements to invest in a hedge fund.[96]

However, in reality, the current framework provides no incentive for hedge funds, which want to avoid regulation under the securities laws, to accept these "sophisticated" lower-net-worth individuals as investors because

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93. *See supra* Part II.C.

94. Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 748 (2009) ("It is underinclusive because otherwise financially knowledgeable investors may be deemed [ineligible to invest] because they do not meet the minimum wealth requirements. Conversely, the accredited investor definition is overinclusive because a financial novice may be deemed [eligible], as long as he or she meets the standard's requirements based upon the accident of being rich." (footnotes omitted)). *But see* Evan M. Gilbert, *Unnecessary Reform: The Fallacies with and Alternatives to SEC Regulation of Hedge Funds*, 2 J. BUS., ENTREPRENEURSHIP & L. 319, 320–21 (2009) (describing the primary criticisms of the growing hedge fund industry as based on the belief that failure of a hedge fund could destroy the "financial system, and the idea that the hedge fund industry, which is supposed to exclude the common layperson investor, is now catering to that very subset of the investing population. . . . [and] the belief that hedge fund fraud is a widespread problem").

95. *See* Finger, *supra* note 95, at 748.

96. *Id.*

accepting these investors risks becoming subject to the securities laws. A hedge fund manager has several incentives to avoid registration. First, a manager may simply want to avoid the onerous requirements of registration and disclosure.[97] Second, unregulated funds are not required to make strategies public and can be more innovative with strategies—providing a significant reason to operate and invest in hedge funds in the first place by offering exclusive and unique tactics not available to the general public.[98] Also, the hedge fund manager has greater flexibility than a regulated fund manager to change the investment strategy without seeking and obtaining permission from directors.[99] In short, registration and disclosure requirements undermine many of the reasons people invest in hedge funds in the first place—the ability to invest in a fund that may employ different strategies to which the general public does not have access.[100]

A hedge fund manager avoids regulations by limiting the types of securities it invests in and the type of investors it accepts—Accredited Investors or Qualified Purchasers. However, the managers have an incentive to accept Qualified Purchasers, who must meet more stringent net-worth requirements than Accredited Investors, to be exempt from both the 1933 Act and 1934 Act regulations. A hedge fund may accept Accredited Investors and be exempt under the 1933 Act, but if a hedge fund limits its investors to Qualified Purchasers, it will be exempt under both the 1933 and 1940 Acts.[101] Thus, in practice hedge funds have an incentive to limit investors to extremely high-net-worth individuals as investors, specifically those with over $5 million, or Qualified Purchasers, to be exempt from regulations under both Acts.

In addition to exempting hedge funds that accept only Qualified Purchasers[102], the 1940 Act also allows an exemption if the fund is limited to 100 investors.[103] Importantly, Qualified Purchasers do not count towards that 100-person limit.[104] However, Accredited Investors do count towards the 100-

97. *See Hedging Their Bets: How Hedge Funds Can Curb Critics and Avoid Regulation*, KNOWLEDGE@WHARTON: FINANCE (Nov. 12, 2008), http://knowledge.wharton.upenn.edu/article/hedging-their-bets-how-hedge-funds-can-curb-critics-and-avoid-regulation (arguing the success of hedge funds requires a "veil of secrecy," and quoting Wharton professor Thomas Donaldson's statement that "[h]edge funds systematically deny information to their own investors and to governments in order to protect their competitive advantage").

98. *See id.*

99. *See id.*

100. *See supra* notes 14–18 and accompanying text.

101. *See supra* notes 52–53, 63 and accompanying text (discussing exemptions for funds accepting Accredited Investors and Qualified Purchasers, respectively).

102. 15 U.S.C. § 80a–7(A) (2012).

103. *Id.* § 80a–3(c)(1).

104. *Id.* § 80a–3(c)(7)(B)(i).

person limit.[105] Thus, a hedge fund has an incentive to accept Qualified Purchasers instead of Accredited Investors because Qualified Purchasers have more money to invest and there is no limit to how many Qualified Purchasers a hedge fund can have.[106] Limiting investors to Qualified Purchasers ensures the fund receives the most capital from the investments of high-net-worth individuals and remains exempt from registration under both the 1933 Act and 1940 Act.

B. *Ignoring Incentives in Existing Regulatory Framework and Proposals*

Because investment managers have an incentive to avoid regulation and thus accept investors based solely on their net worth, any efforts to expand investor eligibility must account for this incentive if those efforts are to have any practical effect. However, current legislation and proposals to expand investor eligibility have ignored these incentives. The Knowledgeable Employee Rule and the efforts of the JOBS Act to allow greater investing in crowdfunding do account for these incentives but remain inadequate, and proposals to expand investor eligibility by expanding who qualifies as an Accredited Investor ignore these incentives.

1. Inadequacy of the JOBS Act and the Knowledgeable Employee Rule

The JOBS Act allows for greater access to investments, but only applies in the very narrow context of crowdfunding through Internet portals where investors contribute small amounts of money to support a new startup.[107] The Knowledgeable Employee Rule, while minimizing incentives to accept only high-net-worth, sophisticated investors, is similarly narrow and is under-inclusive of "sophisticated" investors. A person who meets the criteria of a Knowledgeable Employee is deemed a Qualified Purchaser even without meeting the typical net-worth requirement of five million dollars and, as a Qualified Purchaser, does not count towards the 100-person limit that most hedge funds are subject to.[108] Thus, a hedge fund can accept a Knowledgeable

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105. *See* 17 C.F.R. § 230.501(a) (2016) (defining Accredited Investor); Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2280 (2014) (describing Accredited Investors as a "safe-harbor exemptio[n]" under the 1933 Act).

106. 15 U.S.C. § 80a-3(c)(7). However, in practice, private funds will limit the number of investors they allow to 499 to avoid being subject to the Securities Exchange Act of 1934, which requires reporting by companies with more than $10 million in assets with securities held by over 500 investors. *See* Greupner, *supra* note 24, at 1587 ("Hedge funds avoiding registration under these exceptions are limited to selling interests to either no more than ninety-nine accredited investors or no more than 499 qualified purchasers."); *see also generally Fast Answers: The Laws that Govern the Securities Industry*, *supra* note 25.

107. *Supra* Part II.C.2.

108. The Knowledgeable Employee Rule states:

> For purposes of determining the number of beneficial owners of a Section 3(c)(1) Company [i.e., a company exempt from regulation because it has less than 100 owners], and whether the outstanding securities of a Section 3(c)(7) Company [i.e.,

Employee as an investor without worrying about becoming subject to the registration and disclosure requirements of the 1940 Act and the 1933 Act.

The Knowledgeable Employee Rule, while a step in the right direction towards implementing a "sophisticated" standard that recognizes measures beyond net worth and accounts for incentives to avoid regulation, remains under-inclusive. This measure only applies to a relatively small number of people who happen to work for an investment firm, which is under-inclusive of those with sufficient financial knowledge and experience to allow them to evaluate risk and make investment decisions. Consider, for example, a professor of finance who may be a renowned expert in the area of investment and securities but cannot invest in a hedge fund,[109] or a former portfolio manager who has spent her career investing clients' money in hedge funds but no longer works for an investment firm and thus cannot invest in a hedge fund.

2. Inadequacy of Current Proposals

Similarly, proposals by scholars and practitioners,[110] individuals seeking to invest, and even the SEC have ignored hedge fund managers' incentives to only accept high-net-worth investors by suggesting the possibility of expanding the Accredited Investor definition. Such proposals argue that the same justification for imposing net-worth requirements, namely that investors with a high net worth are also highly sophisticated investors and do not need

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> a company exempt from regulation because it only accepts Qualified Purchasers] are owned exclusively by qualified purchasers, there shall be excluded securities beneficially owned by: (1) A person who at the time such securities were acquired was a Knowledgeable Employee of such Company; (2) A company owned exclusively by Knowledgeable Employees; (3) Any person who acquires securities originally acquired by a Knowledgeable Employee . . . .

17 C.F.R. § 270.3c–5(b) (2016); *see also* Rockas & Ling, *supra* note 81 ("Rule 3c-5 [The Knowledgeable Employee Rule] permits a knowledgeable employee of a [fund typically limited to 100 investors] or a [fund typically limited to Qualified Purchasers] . . . to invest . . . without being counted toward the 100-person limit in Section 3(c)(1) and regardless of whether the knowledgeable employee is a 'qualified purchaser' under Section 3(c)(7).").

109. For example, Steven Davidoff, a law professor at Berkeley who focuses his research on financial regulation and hedge funds, cannot invest in a hedge fund. Davidoff, *supra* note 13 ("Right now, hedge funds are walled off from the public by the [1940 Act] and rules created by the [SEC, which] . . . is why I cannot use my Charles Schwab account to buy into a hedge fund.").

110. *See, e.g.*, Finger, *supra* note 95, at 758–65 (proposing a licensing scheme to measure financial sophistication rather than relying on net-worth and income standards to invest in hedge funds); Oguss, *supra* note 62, at 307–18 (critiquing existing regulations that use wealth as a proxy for sophistication and arguing exam-based alternatives are impractical, and instead proposing statutory changes to the Accredited Investor definition to better reflect the reasons for imposing a net-worth or income-based benchmark); *see also generally* NOVA D. HARB ET AL., THE SEC CONSIDERS UPDATING THE ACCREDITED INVESTOR DEFINITION: A DISCUSSION OF STATUS, SEC ADVISORY COMMITTEE RECOMMENDATIONS, COMMENTS AND PROPOSED LEGISLATION (2015), http://media.mcguirewoods.com/publications/2015/SEC-Considers-Updating-the-Accredited-Investor-Definition.pdf (discussing the efforts of groups of would-be investors, specifically angel investors, to gain access to hedge funds, and the SEC's willingness to consider measures of sophistication beyond net worth).

the government's protection, should also apply to financially sophisticated individuals who do not necessarily meet the net-worth requirements.[111]

Current proposals to provide a definition of "sophisticated" have focused on expanding the Accredited Investor definition, a lower-net-worth requirement than the Qualified Purchaser standard.[112] Expanding the Accredited Investor definition to apply to financially sophisticated individuals would in theory enable hedge funds to accept these investors, but in reality would have little practical effect because the hedge funds would still be inclined to limit their investors to either Qualified Purchasers, in order to be exempt under the 1940 Act, or at least higher-net-worth Accredited Investors, to maximize the capital invested into the fund.[113] Financially sophisticated but low-net-worth Accredited Investors would provide neither of these benefits—neither offering substantial capital nor ensuring exemptions from regulation.

C. How Misaligned Incentives Hurt the Economy

Congress and the SEC have failed to remedy the problem of defining "sophistication" in the context of investor eligibility in a way that implements the policy of allowing sophisticated investors full access to the market. This failure poses significant problems because it has the potential to harm small businesses by making it difficult for them to obtain the capital necessary to grow or even survive, and the economy as a whole stands to suffer when small and midsized businesses are at risk.[114]

Investors, especially those who are knowledgeable business people, are valuable to growing businesses and the economy overall by contributing not only their capital, but also their expertise. It is no surprise that the biggest supporters of expanding the Accredited Investor definition have come from smaller businesses and "angel investors" seeking to invest in those businesses.[115] Under the current framework, only those individuals who work directly for a hedge fund or have a high net-worth are able to invest in most hedge funds, and this is especially problematic in light of the incentives that hedge fund managers have to determine who may invest solely based on net-worth measures.

Expanding the definition of Accredited Investors would have little practical effect when investment managers have no incentive to accept individuals who, while knowledgeable about funds, do not have a high net

111. *See supra* note 111.

112. *Id.*

113. *See supra* Part II.B.

114. *See* Mandelbaum, *supra* note 90 ("[T]he two top reasons small businesses fail in the first five years are a lack of access to capital and a lack of access to expertise.").

115. Quentin Hardy, *Angel Investors Lend Expertise as Well as Cash*, N.Y. TIMES: DEALBOOK (Mar. 31, 2015), http://www.nytimes.com/2015/04/02/business/dealbook/angel-investors-lend-expertise-as-well-as-cash.html (describing angel investors as "working entrepreneurs who like to think of themselves as company-builders, and attack problems").

worth or significant capital to contribute and risk subjecting the fund to increased regulation. However, if Congress and the SEC expanded the definition of a Qualified Purchaser, as they have paved the way for via the Knowledgeable Employee Rule,[116] investment managers and the businesses they represent would have an incentive to take on these investors without being subject to additional regulation. Allowing these investors to invest in private, small and growing businesses would not only help companies access a greater pool of capital, but it would also allow these knowledgeable business people to contribute their expertise to the businesses in which they are investing.[117]

IV. EXPANDING "SOPHISTICATED" UNDER THE QUALIFIED PURCHASER STANDARD

The idea of making investment opportunities available to more of the general population than the extremely rich is one that is gaining traction beyond the world of academia and small businesses in need of investors.[118] The creation and subsequent expansion of the Knowledgeable Employee Rule and the passage of the JOBS Act, which allows the general public to invest in startups through crowdfunding, suggest that Congress and the SEC are willing to expand the criteria for investor eligibility. However, simply changing the definition of an Accredited Investor would be inadequate, given the incentives of hedge funds to limit investors to Qualified Purchasers.[119] Congress should take additional steps to acknowledge the over- and under-inclusivity of net-worth thresholds as the sole measure of financial sophistication by further expanding the Knowledgeable Employee Rule under the 1940 Act. Part IV.A proposes a long-term solution of implementing an exam to measure financial literacy but suggests that, in the meantime, Congress should either amend the existing Knowledgeable Employee Rule, or at a minimum the SEC should take selective enforcement measures by issuing No-Action Letters. Part IV.B discusses possible counter-arguments to those proposals.

A. LONG- AND SHORT-TERM SOLUTIONS

Expanding access to investment opportunities while still ensuring regulation of the financial industry as a whole and preserving the elite status of hedge funds is a lofty goal. However, through a range of long-term solutions with the potential to change the financial industry and shorter-term solutions based on SEC No-Action Letters, expanding access of the financially knowledgeable public to hedge funds is an attainable solution.

116. *See* 17 C.F.R. § 270.3c-5 (2016).

117. *See* Mandelbaum, *supra* note 90 and accompanying text.

118. *Supra* notes 108–14 and accompanying text.

119. *See supra* Part III.

Proposals to expand the Accredited Investor definition often focus on an exam-based solution that would measure the individual's knowledge about investing,[120] and there is no reason the same approach could not apply to expanding the Qualified Purchaser standard. Like an exam measuring the level of "sophistication" required to qualify as an Accredited Investor, an exam for Qualified Purchaser status should measure the individual's ability to assess risks given different investment strategies and fact patterns. An exam-based approach has the advantage of being more targeted to the goal of ensuring knowledge about investments than requiring potential investors to have a certain degree, such as an MBA, CPA, or PhD in an economic or financial subject area.

While an exam-based strategy helps to measure the financial literacy of members of the general public seeking to invest, Congress should also consider amending the existing Knowledgeable Employee Rule to include past employees who participated directly in investing decisions but no longer work for an investment firm. This could be as simple as adding the language "or has previously qualified as" to the definition of a Knowledgeable Employee. Thus, Rule 3(c)(5) would read: "The term *Knowledgeable Employee* . . . means any natural person who is or has previously qualified as: (i) An Executive Officer . . . or (ii) An employee . . . who . . . participates or participated in the investment activities."[121] The current language of the Knowledgeable Employee Rule allows various employees of hedge funds whose advice has a material effect on investment decisions to invest in certain 1940 Act-exempt hedge funds, and these employees must have been in this role or a similar one for at least 12 months.[122] However, there is no reason that, a person who has previously qualified as a Knowledgeable Employee but no longer works for a financial institution, should lose the status of "sophisticated" for purposes of investing in a hedge fund.

The SEC has not addressed the issue of whether past employees who are financially knowledgeable may qualify as Knowledgeable Employees. The SEC should continue to consider these individuals as "sophisticated" under the rule if faced with the issue, either by amending the rule or at least by issuing No-Action Letters when asked. An individual who was previously in a position that would have qualified as a Knowledgeable Employee should continue to retain this "sophisticated" status even if the individual has moved to a different

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120. Finger, *supra* note 95, at 759–65. *But see* J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, a Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 825–27 (2007) (proposing a self-regulation strategy for hedge funds to minimize dangers of excessive hedge fund regulation, such as incentivizing hedge funds to move offshore where "funds [would] still pose the same risk to U.S. markets, but escape any government oversight"); *but see generally* Davidoff, *supra* note 13 (proposing a less-mainstream approach of opening hedge fund investing to the general public and minimizing government regulation altogether).

121. Compare the proposed provision with the current regulation found at 17 C.F.R. § 270.3c-5(a)(4) (2016).

122. *Id.* § 270.3c-5(a)(4)(ii); *see supra* note 75.

career, such as one in academia or otherwise, or since retired. Although these individuals may no longer work for a hedge fund, they still are "sophisticated" and capable of appreciating risks in investments, and they should be included in the Knowledgeable Employee Rule.

Because implementing an exam-based strategy and amending the 1940 Act are unlikely to take effect in the near future, the SEC should not enforce the Qualified Purchaser requirement against companies accepting investors who have demonstrated their knowledge about investment decisions. Companies hoping to accept these investors should write to the SEC describing the individual's investment knowledge, based on her degrees, career, or an exam developed by the company, and the SEC should continue to issue No-Action Letters regarding the Knowledgeable Employee Rule to make clear that the standard for investment should be based on a certain level of sophistication and not solely based on net worth.[123]

B. Considering Counterarguments

Just as commentators have criticized expanding the Accredited Investor definition, there are several possible counterarguments to expanding the Qualified Purchaser definition. First, any expansion of investor eligibility necessarily decreases regulation, and many would argue regulations limiting those who may invest in certain particularly risky investments are necessary to protect the public.[124] However, such sweeping criticisms ignore the narrowness of the proposal to expand the Qualified Purchaser standard. The proposed change would not give the public at large, with no knowledge of investment risks, the ability to lose everything through investment strategies they know nothing about. Rather, expanding the Qualified Purchaser standard would merely continue the work Congress and the SEC have done to create the Knowledgeable Employee Rule. These proposals aim to make the Rule less under-inclusive by including investors who do not currently work for hedge funds but are still highly knowledgeable about investment risks.

Similarly, critics point out a number of problems with the exam-based approach. Critics of an exam-based approach in the Accredited Investor context focus on an exam's inability to measure knowledge of the wide range of hedge fund strategies.[125] Further, implementing an exam system is

123. *But see* Nagy, *supra* note 80, at 941–43 (questioning the degree of reliance the public and recipient should attach to such letters because while "the recipient can consider the letter a promise that the division staff will not bring that particular transaction to the Commission's attention for enforcement action[,] . . . [s]uch a promise . . . probably would not constitute a basis for legal estoppel").

124. *See* SINGER, *supra* note 3, at 59 (arguing regulations are necessary to preserve freedom because "[f]ar from interfering in the free market or undermining economic efficiency, consumer protection law is a cornerstone of well-functioning markets[,] . . . promot[ing] freedom of contract and social welfare and . . . protect[ing] property rights").

125. Oguss, *supra* note 62, at 310–11 ("[T]here is a tremendous range of contemporary investment products, including everything from garden-variety equity securities, debt

expensive—either for the exam-taker, which arguably undermines the purpose of providing access to lower-net-worth investors, or for the federal government, which could undermine the purpose of facilitating investments to help boost the economy.[126] However, the wide range of hedge fund strategies should not hinder an individual's ability to assess risks associated with the different strategies. After all, the current framework allows a wide range of employees of hedge funds to be considered Knowledgeable Employees and therefore able to invest, such as attorneys, traders, members of a risk team, and tax professionals,[127] who surely do not know the intricacies of every hedge fund strategy but have demonstrated their ability to assess risk in the investment context. Investment managers themselves can largely address any cost-based criticisms of an exam system by helping to develop and implement such measures. While developing a uniform exam, which should be updated to reflect changes in the industry, represents an upfront cost, the investment managers could be in charge of implementing such exams to potential investors. Because these companies are already subject to audits as investment advisers, auditing these exams could also become routine at a minimal additional cost.

V. CONCLUSION

Regulation of the financial industry makes sense. When banks and investment managers are given free rein to gamble with people's money, they have an incentive to compete with each other to offer the highest returns at the lowest rates, which inevitably involves the highest risk. When such gambles are not backed by adequate capital, the economy fails. At the same time, too much regulation can prevent the public from accessing the market at all, and a lack of investing prevents the economy from growing and recovering from downturns. The government has correctly identified the key to striking the balance between too much and too little regulation by only allowing "sophisticated" investors who can appreciate the risks associated with certain investments, such as hedge funds, to invest.

The problem, however, is that Congress, the SEC, and the Supreme Court have all failed to adequately describe what it means to be "sophisticated" and have instead settled for using high net worth as a short

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instruments, and plain-vanilla derivatives to highly leveraged interest-rate swaps and CDOS. . . . Accordingly, it is hard to imagine any one exam of a reasonable length that could accurately measure an investor's . . . relevant knowledge in all such contexts.").

126. *See* Finger, *supra* note 95, at 765 (addressing critics of an exam-based proposal who warn that "there would be administrative costs involved with designing the exam and the educational materials used to prepare for it . . . [and] costs [of] administering the exam" by suggesting that "the efficiency gains associated with licensing financially sophisticated individuals far outweigh the administrative costs of the current accredited investor definition, which likely include costly fraud proceedings against con artists and the simple costs of honest mistakes made by uneducated investors who are in over their heads").

127. *See supra* note 75 and accompanying text.

cut for defining sophisticated. Although Congress and the SEC have taken steps to expand "sophisticated" beyond only considering net-worth measures, such steps are inadequate when the government has also created incentives for hedge fund managers to continue limiting investors to only high-net-worth individuals. In its own regulatory framework, the government has found the solution—allowing "sophisticated" investors who are knowledgeable about finance and investing to invest. The government should take the requirement of "sophistication" seriously, both in its legislation and enforcement measures, and should expand the Qualified Purchaser standard to implement this policy.