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# Defining and Verifying Accredited Investors: Effect of Potential SEC Changes on North Carolina's Crowdfunding Statute, the NC PACES Act

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## **Defining and Verifying Accredited Investors: Effect of Potential SEC Changes on North Carolina’s Crowdfunding Statute, the NC PACES Act**

### I. INTRODUCTION

The Securities and Exchange Commission (“SEC”) may adjust the accredited investor definition in the near future,<sup>1</sup> and these changes will likely have a significant impact on the intrastate private offering market in North Carolina. Pursuant to Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the SEC is currently reviewing the accredited investor definition.<sup>2</sup> An official rule has not been proposed, but the SEC released a staff report (“the SEC Report”) reviewing the accredited investor definition on December 18, 2015, which recommended adjusting the current financial thresholds and expanding the current definition by adding additional measures of financial sophistication.<sup>3</sup>

The accredited investor definition is found in Regulation D, Rule 501,<sup>4</sup> but any changes to the accredited investor definition will be felt beyond the context of Regulation D offerings because the accredited investor definition is incorporated into other federal<sup>5</sup> and state exemptions.<sup>6</sup> In North Carolina, the Providing Access to Capital for Entrepreneurs and Small Business Act (“NC PACES Act”), enacted on July 22, 2016, incorporates the accredited investor definition from Rule

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1. Mary Jo White, Chair, Sec. & Exch. Comm’n, Keynote Session: 43rd Annual Securities Regulation Institute (Jan. 26, 2016) (“Going in, my own views on this, is I think the rule needs changing. I don’t think, at least alone, that the net worth and income criteria by themselves are a very good or at least not optimal proxy for who doesn’t need the protections [of the Securities Act], who can fend for themselves in the marketplace.”).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 413(b), 15 U.S.C. § 77b (2015).

3. SEC. & EXCH. COMM’N, REPORT ON THE REVIEW OF THE DEFINITION OF “ACCREDITED INVESTOR” (Dec. 18, 2015).

4. 17 C.F.R. § 230.501 (2016).

5. *See, e.g.*, 17 C.F.R. § 230.251(d)(2)(i)(C) (2016).

6. *E.g.*, 2016 N.C. Sess. Laws 103, N.C. GEN STAT. § 78A-17.1(a)(4) (2016); ALA. CODE § 8-6-11(a)(14) (2016).

501 into its own statutory definitions.<sup>7</sup> The accredited investor definition is critically important to the NC PACES Act because purchasers qualifying as accredited investors under Rule 501 are not subject to investment limitations, while non-accredited investors are limited to investing \$5,000 per offering.<sup>8</sup>

This Note examines potential changes to the accredited investor definition and how these changes will likely impact entrepreneurs and small businesses relying on the NC PACES Act. This Note proceeds in five parts. Part II provides a synopsis of the accredited investor definition and certain private offerings, including the NC PACES Act, which incorporate the accredited investor definition.<sup>9</sup> Part III discusses potential changes to the accredited investor definition and evaluates their likely impact on offerings under the NC PACES Act.<sup>10</sup> Part IV discusses the different regulatory approaches for verifying accredited investors.<sup>11</sup> Part V concludes with recommendations for minimizing the negative impacts of possible changes to the accredited investor definition on offerings under the NC PACES Act.<sup>12</sup>

## II. THE ACCREDITED INVESTOR DEFINITION AND OFFERINGS OF SECURITIES EXEMPT FROM REGISTRATION

Unless an exemption applies, all offers and sales of securities must be registered with the SEC prior to being offered to investors.<sup>13</sup> Section 4(a)(2) of the Securities Act of 1933 exempts “transactions by an issuer not involving any public offering,” so-called private placements.<sup>14</sup> The Supreme Court has held that “[a]n offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.”<sup>15</sup>

In 1982, the SEC adopted Regulation D, which sets forth a number of exemptions from the normal registration requirements.<sup>16</sup>

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7. N.C. GEN STAT. § 78A-17.1.

8. N.C. GEN STAT. § 78A-17.1(a)(4).

9. *See infra* Part II.

10. *See infra* Part III.

11. *See infra* Part IV.

12. *See infra* Part V.

13. The Securities Act of 1933, 15 U.S.C. § 77a (2015).

14. Securities Act § 4(a)(2), 15 U.S.C. § 77d(a)(2).

15. *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (internal citation omitted).

16. Revision of Certain Exemptions from Registration for Transactions Involving

Regulation D was adopted in order to “simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors.”<sup>17</sup> Regulation D consists of six rules and three<sup>18</sup> exemptions, which replaced the exemptions in Rules 146, 240, and 242.<sup>19</sup>

A. *Accredited Investor Definition*

Regulation D incorporates the accredited investor definition provided under Rule 501.<sup>20</sup> As it applies to natural persons, the accredited investor definition includes “[a]ny director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer” as well as any individual who meets the specified income or net worth threshold.<sup>21</sup> According to the SEC, accredited investors are “persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.”<sup>22</sup>

A natural person, unaffiliated with the issuer, will qualify as an accredited investor based on income, if either his individual income is at least \$200,000 in the two most recent years or his joint income with his spouse is at least \$300,000 in the two most recent years.<sup>23</sup> Apart from the annual income thresholds, a natural person, unaffiliated with the issuer, will also qualify as an accredited investor based on net worth, if

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Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,252 (Mar. 16, 1982).

17. *Id.* at 11251.

18. The SEC recently announced that it is repealing Rule 505, but the repeal will not be effective until May 22, 2017. Press Release, SEC. & EXCH. COMM’N, SEC Adopts Final Rules to Facilitate Interstate and Regional Securities Offerings: Rules Provide More Options for Companies to Raise Money While Maintaining Investor Protections (Oct. 26, 2016), <https://www.sec.gov/news/pressrelease/2016-226.html>.

19. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. at 11,252.

20. 17 C.F.R. § 230.501 (2016).

21. 17 C.F.R. § 230.501(a)(4)–(5).

22. Regulation D Revisions; Exemption for Certain Employee Benefit Plans, 52 Fed. Reg. 3,015 (Jan. 16, 1987).

23. 17 C.F.R. § 230.501(a)(6). Individuals qualifying as accredited investors on the basis of income must also have a reasonable expectation that they will meet the income thresholds in the current year. *Id.*

either his individual or joint net worth with his spouse is at least \$1,000,000, excluding the value of his primary residence.<sup>24</sup>

Since the adoption of Regulation D in 1982, the income component of the accredited investor definition has only been adjusted once.<sup>25</sup> In 2010, Congress included a provision in Dodd-Frank which excluded the value of an investor's primary residence in determining an investor's net worth.<sup>26</sup> This adjustment was the first significant change to the net worth component of the accredited investor definition since 1982.<sup>27</sup> Dodd-Frank further instructs the SEC to periodically review the accredited investor definition "to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy."<sup>28</sup> Although the accredited investor definition is found in Regulation D, the definition is used by numerous registration exemptions to determine whether investors may take part in a private offering and to what extent they may do so.

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24. 17 C.F.R. § 230.501(a)(5).

25. Regulation D Revisions, 53 Fed. Reg. 7,870 (Mar. 3, 1988); *see also* SEC. & EXCH. COMM'N, *supra* note 3, at 19 (explaining that the addition of a joint income standard in 1988 has been the only change to the income standard since it was adopted in 1982).

26. Section 413(a) of the Dodd-Frank Act provides that "[t]he Commission shall adjust any net worth standard for an accredited investor, as set forth in the rules of the Commission under the Securities Act of 1933, so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than \$1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person, except that during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be \$1,000,000, excluding the value of the primary residence of such natural person." Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 413(b), 15 U.S.C. § 77b (2015). *See also* Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793, 81,793 (Dec. 29, 2011) ("We are adopting amendments to the accredited investor standards in our rules under the Securities Act of 1933 to implement the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act requires the definitions of 'accredited investor' in our Securities Act rules to exclude the value of a person's primary residence for purposes of determining whether the person qualifies as an 'accredited investor' on the basis of having a net worth in excess of \$1 million.").

27. SEC. & EXCH. COMM'N, *supra* note 3, at 18–19.

28. Dodd-Frank § 413(b), 15 U.S.C. § 77b (2015). Inflation has eroded the financial thresholds to such an extent that doubling them would not sufficiently adjust them for inflation. RACHITA GULLAPALLI, DIV. OF ECON. AND RISK ANALYSIS, SEC. & EXCH. COMM'N, ACCREDITED INVESTOR POOL, FORUM ON SMALL BUSINESS CAPITAL FORMATION (Nov. 20, 2014), <https://www.sec.gov/info/smallbus/sbforum112014-gullapalli.pdf>.

B. *Intrastate Crowdfunding Exemptions and the Accredited Investor Definition: The NC PACES Act*

The final rules implementing Title III of the Jumpstart Our Business Startups Act<sup>29</sup> (“JOBS Act”) did not go into effect until May 16, 2016, over four years after President Barack Obama signed the JOBS Act.<sup>30</sup> The four-year delay between the signing of the JOBS Act and the effective date of the final rules implementing Title III created an opportunity for individual states to implement intrastate crowdfunding exemptions.<sup>31</sup> As of November 16, 2016, thirty-three states have intrastate crowdfunding exemptions in effect.<sup>32</sup> Three other states, including North Carolina, have adopted an intrastate crowdfunding

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29. Jumpstart Our Business Startups Act (“JOBS Act”) § 301 (2015) (codified as amended in scattered sections of 15 U.S.C.).

30. On April 5, 2012, President Barack Obama signed the JOBS Act, which was touted as a way for “ordinary Americans . . . to go online and invest in entrepreneurs that they believe in.” President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), <https://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing>. The SEC undertook a lengthy rulemaking process to implement Title III of the JOBS Act, which added Section 4(a)(6), 15 U.S.C. § 77d(a)(6), to the Securities Act of 1933, culminating with the rules becoming effective on May 16, 2016. Crowdfunding, 80 Fed. Reg. 71,387 (Nov. 16, 2015). The SEC refers to the rules governing the exemption in Section 4(a)(6) as Regulation Crowdfunding. Crowdfunding, 80 Fed. Reg. at 71,387. Issuers relying on the Regulation Crowdfunding exemption are authorized to raise a maximum of \$1,000,000 per year. 17 C.F.R. § 227.100(a)(1) (2016). The Regulation Crowdfunding exemption contains investment limitations for investors, but unlike the NC PACES Act, the investment limitations do not depend upon the accredited investor definition. § 227.100(a)(2). Instead, the investment limitations divide investors into two groups based on whether or not an investor has an income of \$100,000 per year and a net worth of \$100,000. *Id.* If either of an investor’s net worth or annual income is below \$100,000, the investor is limited to investing “[t]he greater of \$2,000 or [5%] of the lesser of the investor’s annual income or net worth.” *Id.* If an investor has both an income and net worth of at least \$100,000, then they are permitted to invest 10% of the lesser of either their net worth or income, but they may not invest more than \$100,000 per year in all offerings relying on the Section 4(a)(6) exemption. *Id.* Issuers relying on the Regulation Crowdfunding, unlike investors under the NC PACES Act, are required to exclusively use a registered intermediary to conduct an offering. § 227.100(a)(3). Due to the complex nature of the investment limitations in Regulation Crowdfunding, issuers are permitted to rely on an intermediary to verify the compliance of investors with the investment limitations, “provided that the issuer does not know that the investor has exceeded the investor limits or would exceed the investor limits as a result of purchasing securities in the issuer’s offering.” § 227.100 Instruction 3 to paragraph (a)(2).

31. Stacy Cowley, *Tired of Waiting for U.S. to Act, States Pass Crowdfunding Laws and Rules*, N.Y. TIMES (June 3, 2015), <http://www.nytimes.com/2015/06/04/business/smallbusiness/states-pass-crowdfunding-laws-for-small-businesses.html>.

32. N. Am. Secs. Adm’rs’ Ass’n, *NASAA Intrastate Crowdfunding Update 2* (Nov. 16, 2016), <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Intrastate-Crowdfunding-Update-111616.pdf>.

exemption and are in the process of issuing final rules implementing these exemptions.<sup>33</sup> In addition to the thirty-six states that have adopted an intrastate crowdfunding exemption, legislation has been introduced in five other states to establish an intrastate crowdfunding exemption.<sup>34</sup> While many intrastate crowdfunding exemptions were initially proposed in response to the SEC's delayed issuance of rules implementing Title III of the JOBS Act, Regulation Crowdfunding is a separate and distinct registration exemption, authorized by Section 4(a)(6) of the Securities Act of 1933<sup>35</sup> and does not replace or preempt intrastate crowdfunding exemptions authorized under Section 3(a)(11) of the Securities Act of 1933<sup>36</sup> and Rule 147.<sup>37</sup>

North Carolina's crowdfunding exemption, the NC PACES Act, signed into law on July 22, 2016, is designed to facilitate the formation of capital for small businesses and entrepreneurs.<sup>38</sup> The NC PACES Act permits entrepreneurs and small businesses to raise more than the

\$1 million maximum permitted under Regulation Crowdfunding.<sup>39</sup> Under the NC PACES Act, issuers may raise a maximum of either \$1 million or \$2 million per year through the sale of securities.<sup>40</sup> In order to qualify for the \$2 million limit, an issuer must submit audited financial statements to investors and state securities regulators.<sup>41</sup> Otherwise, the \$1 million limit applies to issuers who do not submit audited financial statements to investors and state securities regulators.<sup>42</sup>

Sales and offerings under the NC PACES Act are limited to residents of North Carolina, but all residents of North Carolina—not just accredited investors—are permitted to purchase at least some securities under the Act.<sup>43</sup> Although the NC PACES Act allows issuers

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33. *Id.*

34. *Id.*

35. 15 U.S.C. § 77d(a)(6) (2015).

36. 15 U.S.C. § 77c(a)(11) (2015).

37. 17 C.F.R. § 230.147 (2016).

38. Lauren K. Ohnesorge, *It's Official: Gov. Signs Off on N.C. Crowdfunding Law*, TRIANGLE BUS. J. (July 22, 2016), [http://www.bizjournals.com/triangle/news/2016/07/22/its-official-gov-signs-off-onn-c-crowdfunding-law.html?ana=e\\_du\\_pap&s=article\\_du&ed=2016-07-22&u=PjXOK5iAKMyv60BA51Rptw0e38d8a3&t=1469217123&j=75092892](http://www.bizjournals.com/triangle/news/2016/07/22/its-official-gov-signs-off-onn-c-crowdfunding-law.html?ana=e_du_pap&s=article_du&ed=2016-07-22&u=PjXOK5iAKMyv60BA51Rptw0e38d8a3&t=1469217123&j=75092892).

39. 17 C.F.R. § 227.100(a)(1) (2016); N.C. GEN STAT. § 78A-17.1(a)(3) (2016).

40. N.C. GEN STAT. § 78A-17.1(a)(3).

41. N.C. GEN STAT. § 78A-17.1(a)(3)(b).

42. N.C. GEN STAT. § 78A-17.1(a)(3)(a).

43. N.C. GEN STAT. § 78A-17.1(a)(9)(b). Issuers relying on the NC PACES Act must

to raise capital from accredited and non-accredited investors, non-accredited investors may not contribute more than \$5,000 per issuer in one year.<sup>44</sup> Unlike Regulation Crowdfunding,<sup>45</sup> the NC PACES Act does not impose investment limitations on accredited investors.<sup>46</sup> If an issuer relying on the NC PACES Act receives more than \$5,000 per year from an investor, the issuer bears the burden of demonstrating that the investor is in fact an accredited investor.<sup>47</sup>

The investment limitations in the NC PACES Act, along with nearly every other intrastate crowdfunding exemption, are statutorily tied to the accredited investor definition in Rule 501.<sup>48</sup> The NC PACES Act uses the accredited investor definition from Rule 501 to impose investment limitations, as opposed to investment limitations based on a percentage of an investor's income or net worth.<sup>49</sup> Therefore, the investment limitations in the NC PACES Act are less stringent and less complicated than those found in Regulation Crowdfunding.<sup>50</sup>

Although Regulation Crowdfunding imposes more complicated investment limitations based on a percentage of either an investor's net worth or income, these limitations are statutorily independent from the accredited investor definition.<sup>51</sup> While the NC PACES Act provides issuers with relatively simple investment limitations, the simplicity of these limitations is entirely dependent upon the SEC's accredited investor definition.<sup>52</sup> Thus, any changes to the accredited investor

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comply with Rule 147, which requires that "offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident." 17 C.F.R. § 230.147(4)(d).

44. N.C. GEN STAT. § 78A-17.1(a)(4).

45. 17 C.F.R. § 227.100(a)(1) (2016).

46. N.C. GEN STAT. § 78A-17.1(a)(4).

47. N.C. GEN STAT. § 78A-17.1(a)(9)(b).

48. *See, e.g.*, ALA. CODE § 8-6-11(a)(14); ALASKA STAT. § 45.55.175(a); ARIZ. REV. STAT. ANN. § 44-1844(D); COLO. REV. STAT. § 11-51-308.5; DEL. CODE ANN. tit. 6, §73-207; FLA. STAT. § 517.0611; GA. COMP. R. & REGS. 590-4-2.08; IDAHO CODE §§ 30-14-203; 815 ILL. COMP. STAT. 5/2.34; IOWA CODE § 502.202(24); IND. CODE § 23-19-2-2; KAN. ADMIN. REGS. § 81-5-21; KY. REV. STAT. ANN. §292.411; ME. STAT. tit. 32 § 16304; 950 MASS. CODE REGS. 14.402; MICH. COMP. LAWS ANN. § 451.2202; MINN. STAT. § 80A.461; MONT. CODE ANN. § 30-10-105; NEB. REV. STAT. §8-1111; S.C. CODE REGS. § 13-206; TENN. CODE ANN. § 48-1-103; 7 TEX. ADMIN. CODE § 139.25; 4-4 VT. CODE R. § 8; VA. CODE ANN. § 13.1-514; WIS. STAT. § 551.202. *Contra* MD. CODE ANN. CORPS. & ASS'NS § 11-601.

49. N.C. GEN STAT. ANN § 78A-17.1.

50. 17 C.F.R. § 227.100(a)(1) (2016); N.C. GEN STAT. § 78A-17.1.

51. Securities Act § 4(a)(6), 15 U.S.C. § 77d(a)(6) (2015).

52. N.C. GEN. STAT. § 78A-17.1(a)(4) (2016).

definition will impact potential issuers and investors under the NC PACES Act.

*C. Regulation A*

Pursuant to Section 401 of the JOBS Act, the SEC amended Regulation A to establish two tiers of Regulation A offerings.<sup>53</sup> Issuers are permitted to raise \$20 million per year under Tier I<sup>54</sup> and \$50 million per year under Tier II.<sup>55</sup> Regulation A uses the accredited investor definition to implement investment limitations.<sup>56</sup> The investment limitations in Regulation A only apply to non-accredited investors who participate in a Tier II offering.<sup>57</sup> Under Regulation A, non-accredited investors are limited to investing the greater of 10% of their annual income or net worth.<sup>58</sup> Additionally, the investment limitations in Regulation A do not apply when the securities purchased by an investor will be “listed on a registered national securities exchange upon qualification.”<sup>59</sup>

*D. Rule 506*

Rule 506,<sup>60</sup> until September 23, 2013,<sup>61</sup> contained a single

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53. 17 C.F.R. § 230.251 (2016). *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,805, 21,807 (Apr. 20, 2015) (“We are adopting final rules to implement the JOBS Act mandate by expanding Regulation A into two tiers: Tier 1, for securities offerings of up to \$20 million; and Tier 2, for offerings of up to \$50 million.”).

54. 17 C.F.R. § 230.251(a)(1).

55. 17 C.F.R. § 230.251(a)(2).

56. 17 C.F.R. § 230.251.

57. 17 C.F.R. § 230.251(d)(2)(C).

58. 17 C.F.R. § 230.251(d)(2)(C)(1).

59. 17 C.F.R. § 230.251(d)(2)(C). *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,805, 21,807 (Apr. 20, 2015).

60. 17 C.F.R. § 230.506 (2016).

61. The SEC proposed amendments to Rule 506 on August 29, 2012, to comply with Section 201(a) of the JOBS Act, which called for the SEC to lift the ban on general solicitation and advertising for Rule 506 offerings when all of the purchasers are accredited investors. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54,464 (Sep. 4, 2012). The final rules became effective on September 23, 2013. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (Jul. 24, 2013).

exemption, which allowed issuers to raise an unlimited amount of capital from an unlimited number of accredited investors and up to thirty-five sophisticated non-accredited investors.<sup>62</sup> Pursuant to Section 201 of the JOBS Act,<sup>63</sup> the SEC amended Rule 506 to include Rule 506(c), which allows issuers to use general solicitation and general advertising to raise an unlimited amount of capital from accredited investors.<sup>64</sup> The original Rule 506 exemption—now Rule 506(b)—still requires issuers to comply with the ban on general solicitation and general advertising found in Rule 502(c).<sup>65</sup>

The biggest advantage of the Rule 506(c) exemption is that it allows issuers to engage in general solicitation and general advertising, which includes “[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising.”<sup>66</sup> Issuers relying on Rule 506(c) undoubtedly benefit from expanded exposure to investors, but this exposure comes at the cost of offerings being limited to only accredited investors who must be verified according to a heightened verification standard.<sup>67</sup>

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62. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,773.

63. JOBS Act § 201(a)(1), 15 U.S.C. § 77d(2) (2015).

64. § 230.506(c). See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,776 (“Under new Rule 506(c), issuers can offer securities through means of general solicitation, provided that they satisfy all of the conditions of the exemption.”).

65. 17 C.F.R. § 230.502(c).

66. 17 C.F.R. § 230.502(c)(1), (2). Rule 502 is clear that other forms of communication may be considered “general solicitation or general advertising.” *Id.* Other forms of communication permitted under Rule 506(c) include “cold calls, e-mail blasts, social media or advertisements over the Internet.” LAWRENCE B. MANDALA, RANDALL G. RAY & JEFFREY M. MCPHAUL, CLIENT ALERT: PRIVATE OFFERINGS UNDER THE SEC’S NEW RULES: PRACTICAL IMPLICATIONS AND ACTIONS TO CONSIDER NOW, MUNCK WILSON MANDALA LLP (Sep. 2013), <https://www.munckwilson.com/sites/default/files/Client%20Alert%209-13.pdf>.

67. 17 C.F.R. § 230.506(c). See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,778 (“[W]e are adopting as a condition of new Rule 506(c) the requirement that issuers take ‘reasonable steps to verify’ that purchasers of the offered securities are accredited investors. This requirement is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors.”).

### III. CHANGES TO THE ACCREDITED INVESTOR DEFINITION AND THE IMPACT ON OFFERINGS CONDUCTED PURSUANT TO THE NC PACES ACT

The recommendations from the SEC Report can be divided into two categories: recommendations dealing with the financial thresholds and recommendations dealing with alternative measures of sophistication.<sup>68</sup> While the SEC Report acknowledges that the recommended changes to the accredited investor definition in Rule 501 will reverberate outside of the context of Regulation D offerings,<sup>69</sup> the report fails to address how these changes may affect intrastate crowdfunding statutes such as the NC PACES Act.<sup>70</sup>

#### A. *The Financial Thresholds*

Most importantly, the SEC Report discusses the possibility of adjusting the current financial thresholds for inflation.<sup>71</sup> If the current financial thresholds were adjusted for inflation, the individual income threshold would increase from \$200,000 to roughly \$492,958, the joint income threshold from \$300,000 to roughly \$628,130, and the net worth threshold from \$1,000,000 to roughly \$2,464,788.<sup>72</sup> The Report recommends increasing the current individual income threshold from \$200,000 to \$500,000, the current joint income threshold from \$300,000 to \$750,000, and the current net worth threshold from \$1,000,000 to \$2,500,000.<sup>73</sup>

When Regulation D was adopted in 1982, only 1.8% of households in the United States qualified under either the income or net worth standards.<sup>74</sup> By 2013, 10.1% of households qualified under either the net worth or income standards.<sup>75</sup> If these inflation-based revisions were incorporated, only 3.6% of U.S. households would qualify as accredited investors.<sup>76</sup> Such a significant change to the pool of

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68. SEC. & EXCH. COMM'N, *supra* note 3, at 89–96.

69. SEC. & EXCH. COMM'N, *supra* note 3, at 85–88.

70. N.C. GEN. STAT. § 78A-17.1 (2016).

71. SEC. & EXCH. COMM'N, *supra* note 3, at 89.

72. Gullapalli, *supra* note 28.

73. SEC. & EXCH. COMM'N, *supra* note 3, at 90–91.

74. SEC. & EXCH. COMM'N, *supra* note 3, at 48.

75. *Id.*

76. SEC. & EXCH. COMM'N, *supra* note 3, at 105.

accredited investors demands consideration of its potential economic effects in light of the policy objectives Regulation D seeks to advance.

Chiefly, free market proponents argue that decreasing the size of the accredited investor pool would inhibit the ability of small businesses to raise capital and perpetuate the federal government's excessive economic paternalism.<sup>77</sup> Those sharing this perspective argue that such adjustments would have a substantial negative impact on "a strong capital network that fosters job creation and innovation nationwide,"<sup>78</sup> particularly since accredited investors have been the primary source of funding for the successful startups that have accounted for the majority of the job growth in past decades.<sup>79</sup> Further, because of the frequency with which startups serve a research and development function for larger companies, a smaller accredited investor pool could even affect well-established companies.<sup>80</sup> While begrudgingly acknowledging the need for some investor protection, this anti-paternalism approach characterizes inflation-adjusted financial thresholds as "thwart[ing] upward mobility" by excluding a greater number of lower-income individuals from potentially lucrative investment opportunities.<sup>81</sup> Finally, those opposed to inflation-based adjustments contend that there is insufficient evidence of accredited investors being unable to bear investment losses to warrant such a drastic decrease in the amount of capital accessible to small businesses.<sup>82</sup>

Those who argue for the inadequacy of the current financial thresholds similarly cite the importance of accessible capital, but contend that decreased access is more likely to be caused by swindled investors exiting the market than increased financial thresholds excluding would-be investors.<sup>83</sup> The North American Securities

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77. See, e.g., Comment Letter from Angel Capital Ass'n to Mary Jo White, Chairman, Sec. & Exch. Comm'n at 1 (Feb. 28, 2014), <https://www.sec.gov/comments/s7-06-13/s70613-490.pdf>.

78. *Id.*

79. *Id.*

80. *Id.*

81. David R. Burton, *Ideas for Improving Small Businesses' Access to Capital* 9 (Nat'l Small Bus. Ass'n White Paper Sept. 10, 2013), <http://www.nsba.biz/wp-content/uploads/2013/09/NSBA-White-Paper-on-Improving-Small-Business-Access-to-Capital.pdf>.

82. Comment Letter from Brett Palmer, Pres. of the Small Bus. Investor Alliance 2 (Mar. 7, 2016), <https://www.sec.gov/comments/4-692/4692-15.pdf>.

83. Comment Letter from A. Heath Abshire, Pres., N. Am. Sec. Admin. Ass'n 1 (Sept. 27, 2013), <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf>.

Administrators Association, comprised of state-level securities regulators, notes that Rule 506 offerings have led to most of the enforcement actions brought by state legislatures, and that “private placements are commonly listed on [the] annual list of top investor traps.”<sup>84</sup> This pro-regulatory approach argues that failing to implement inflation-adjusted financial thresholds is counter to the fundamental purpose of Rule 506 to allow exemptions for only those unquestionably capable of bearing the losses associated with lesser regulated securities.<sup>85</sup> Further, in light of Rule 506(c)’s general solicitation authorization, the accredited investor definition is of increased importance because it is now “the only safeguard in place to ensure that investors in Rule 506 offerings are capable of fending for themselves.”<sup>86</sup>

#### 1. Inflation Adjusted Financial Thresholds Not Subject to Investment Limitations

The SEC Report recommends adjusting the financial thresholds to account for inflation for the first time since they were implemented.<sup>87</sup> Investors qualifying under the inflation-adjusted thresholds will not be affected by this recommendation since they already qualify under the current standards, which do not impose investment limitations.<sup>88</sup> Thus an investor with an annual income of \$500,000, a joint income of \$750,000, or a net worth of \$2,500,000 would not be subject to the investment limitations discussed in the SEC Report.<sup>89</sup>

This possible change will not affect investors who qualify under the inflation-adjusted thresholds, but it will impact issuers and current accredited investors who do not qualify under the inflation-adjusted thresholds. The Report estimates that 72% of households qualifying under the current income thresholds would not qualify under the inflation-adjusted income thresholds.<sup>90</sup> The Report also concludes that

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<sup>84</sup> *Id.*

<sup>85</sup> Comment Letter from Paul Schott Stevens, Pres. & CEO, Inv. Co. Inst. 8 (Sept. 23, 2013), <https://www.sec.gov/comments/s7-06-13/s70613-398.pdf>.

<sup>86</sup> Comment Letter from Am. for Fin. Reform and the Am. Fed. of Labor and Cong. 3 (Oct. 5, 2012), <https://www.sec.gov/comments/s7-07-12/s70712-140.pdf>.

<sup>87</sup> SEC. & EXCH. COMM’N, *supra* note 3, at 91.

<sup>88</sup> SEC. & EXCH. COMM’N, *supra* note 3, at 91.

<sup>89</sup> SEC. & EXCH. COMM’N, *supra* note 3, at 91.

<sup>90</sup> SEC. & EXCH. COMM’N, *supra* note 3, at 99–100.

60% of households qualifying under the current net worth threshold would not qualify under the inflation-adjusted net worth threshold.<sup>91</sup>

While such adjustments would decrease the size of the accredited investor pool across the board, increased financial thresholds would disproportionately impact lower income states.<sup>92</sup> Thus, lower income states like North Carolina<sup>93</sup> with intrastate crowdfunding exemptions incorporating Rule 501's accredited investor definition would experience a significant reduction in the amount of capital accessible to small businesses and entrepreneurs.<sup>94</sup> By making it more difficult for individuals to invest in entities within the state, such a decrease in accessible capital would further perpetuate geographical income disparities and their recursive effects.<sup>95</sup> Accordingly, as further discussed below, if inflation adjusted financial thresholds were adopted, lower income states would need to incorporate into any intrastate crowdfunding exemption an accredited investor definition more closely tailored to the particular income demographics of the state.

To demonstrate the severe potential impact that increased financial thresholds would have on lower income states, consider that the United States Census Bureau estimates that there are approximately 135,924 individuals in North Carolina with an annual income of \$200,000 or more.<sup>96</sup> This translates to approximately one accredited investor, qualifying under the income threshold, for every seventy-four people in North Carolina.<sup>97</sup> If 72% of these accredited investors no longer qualified under the inflation-adjusted thresholds, as the SEC

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91. SEC. & EXCH. COMM'N, *supra* note 3, at 99–100.

92. Comment Letter from Frank Knapp Jr., Pres. & CEO, South Carolina Small Bus. Chamber of Commerce 1 (Sept. 17, 2014), <https://www.sec.gov/comments/s7-06-13/s70613-586.pdf>.

93. Whereas the most recent estimated median income for households in the United States is \$53,889, the estimated median income for households in North Carolina is only \$46,868. U.S. CENSUS BUREAU, SELECTED ECONOMIC CHARACTERISTICS, 2011–2015 AMERICAN COMMUNITY SURVEY 5-YEAR ESTIMATES, [https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS\\_15\\_5YR\\_DP03&prodType=table](https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_15_5YR_DP03&prodType=table). The United States Census Bureau estimates that 5.3% of households in the United States have an annual income of \$200,000 or more, but only 3.6% of households in North Carolina have an estimated annual income of \$200,000 or more. *Id.*

94. Knapp, *supra* note 92, at 1.

95. Knapp, *supra* note 92, at 1.

96. U.S. CENSUS BUREAU, SELECTED ECONOMIC CHARACTERISTICS, 2011–2015 AMERICAN COMMUNITY SURVEY 5-YEAR ESTIMATES, [https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS\\_15\\_5YR\\_DP03&prodType=table](https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_15_5YR_DP03&prodType=table).

97. *Id.*

Report predicts,<sup>98</sup> then the approximate number of accredited investors based on income in North Carolina would decrease from 135,924 to 38,059.<sup>99</sup> The ratio of accredited investors would change to approximately one accredited investor per 264 people in North Carolina.<sup>100</sup> Such a drastic decrease in accessible capital would have both serious immediate consequences as well as detrimental long-term effects. In the short-term, such a swift drop off would likely drown nascent companies relying on capital from accredited investors to keep their heads above water, while also erecting barriers to entry making it more difficult for entrepreneurs and small businesses to get off the ground.<sup>101</sup> In the long-term, without intervention, such a situation would likely further contribute to income disparity and its multitude of concomitant social and economic issues.<sup>102</sup>

## 2. Investment Limitations and Financial Thresholds

Clearly wary of the aforementioned problems, to avoid disqualifying over 7 million households, the SEC Report proposes investment limitations for individuals “who qualify as accredited investors solely based on [the current financial thresholds],” and would not otherwise qualify under inflation-adjusted financial thresholds.<sup>103</sup>

When the Report first discussed investment limitations for accredited investors, it pointed to the investment limitations found in Regulation A<sup>104</sup> and Regulation Crowdfunding<sup>105</sup> to argue that it would be feasible to impose investment limitations on accredited investors under Regulation D.<sup>106</sup> The Report’s final recommendations suggest an investment limitation of “10% of prior year income or 10% of net worth, as applicable, per issuer, in any 12-month period,”<sup>107</sup> which

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98. SEC. & EXCH. COMM’N, *supra* note 3, at 99–100.

99. SEC. & EXCH. COMM’N, *supra* note 3, at 99–100.

100. SEC. & EXCH. COMM’N, *supra* note 3, at 99–100.

101. Knapp, *supra* note 91, at 1.

102. MARKUS BRÜCKNER & DANIEL LEDERMAN, *Effects of Income Inequality of Economic Growth*, VOXEU.ORG (July 7, 2015), <http://voxeu.org/article/effects-income-inequality-economic-growth>.

103. SEC. & EXCH. COMM’N, *supra* note 3, at 90.

104. 17 C.F.R. § 230.251(d)(2)(i)(C) (2016).

105. 15 U.S.C. § 77d(a)(6)(B) (2015).

106. SEC. & EXCH. COMM’N, *supra* note 3, at 52.

107. SEC. & EXCH. COMM’N, *supra* note 3, at 90.

indicates that the investment limitations would be “per issuer,” similar to the investment limitations in Regulation A,<sup>108</sup> instead of aggregate investment limitations, which are used in Regulation Crowdfunding.<sup>109</sup>

The distinction between “per issuer” and aggregate investment limitations is critically important for issuers relying on the NC PACES Act exemption.<sup>110</sup> Under the “per issuer” approach, an issuer must limit the amount that an investor may invest to a percentage of the investor’s annual income or net worth.<sup>111</sup> Under the aggregate investment approach, an issuer must obtain information from an investor detailing all of the investments that the investor has made that year and determine the amount that the investor may invest in the issuer’s offering.<sup>112</sup> The aggregate investment approach used in Regulation Crowdfunding depends upon the requirement that issuers use intermediaries to conduct offerings.<sup>113</sup> Since the NC PACES Act does not require issuers to use an intermediary to conduct an offering,<sup>114</sup> an aggregate investment limitation would likely be ineffective, difficult to implement, and raise serious concerns about investor privacy.<sup>115</sup>

While the SEC Report recommends adopting “per issuer” investment limitations similar to those found in Regulation A, the SEC Report is extremely vague on whether the investment limitations on accredited investors should be calculated using the “lesser of” or the “greater of” approach.<sup>116</sup> The Report gives the example of “10% of

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108. 17 C.F.R. § 230.251(d)(2)(i)(C). *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,805, 21,877 (Apr. 20, 2015).

109. 17 C.F.R. § 227.100(a)(2) (“The aggregate amount of securities sold to any investor across all issuers in reliance on Section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) during the 12-month period preceding the date of such transaction, including the securities sold to such investor in such transaction, shall not exceed . . .”).

110. N.C. GEN STAT. § 78A-17.1 (2016).

111. 17 C.F.R. § 230.251(d)(2)(i)(C).

112. 17 C.F.R. § 227.100(a)(2).

113. 17 C.F.R. § 227.100(a)(3). *See also* Crowdfunding, 80 Fed. Reg. 71,387, 71,443–71,445 (Nov. 16, 2015).

114. N.C. GEN STAT. § 78A-17.1(a)(9).

115. *See* Crowdfunding, 80 Fed. Reg. 71,387 at 71,444 (“While several commenters opposed permitting an intermediary to rely on the representations of an investor about investment limits and some suggested requiring intermediaries to take certain affirmative steps to verify compliance, we believe that it would be difficult for intermediaries to monitor or independently verify whether each investor remains within his or her investment limits where the investor may be participating in offerings on multiple platforms.”).

116. SEC. & EXCH. COMM’N, *supra* note 3, at 90.

prior year income or 10% of net worth,” but it does not specify whether the investor should make the calculation based on the greater or lesser value.<sup>117</sup>

The SEC applies the “lesser of” approach to calculating the maximum investment permitted in the context of Regulation Crowdfunding offerings.<sup>118</sup> Under the “lesser of” approach used in Regulation Crowdfunding, an investor with a net worth and income of \$100,000 or more is limited to investing the lesser of 10% of his or her income or net worth and may not invest more than \$100,000 per year.<sup>119</sup> The “lesser of” approach is designed to protect individuals who have a large disparity between income and net worth.<sup>120</sup> The SEC applies the “greater of” approach to calculating the maximum investment permitted in the context of Regulation A.<sup>121</sup> Under the “greater of” approach utilized in Regulation A, an investor is limited to investing the greater of 10% of his or her income or net worth.<sup>122</sup> The “greater of” approach is also designed to facilitate capital formation while protecting investors from potentially catastrophic losses.<sup>123</sup> Issuers and investors relying upon the NC PACES Act need to follow the proposed investment limitations closely because the approach for calculating maximum investments could further limit the amount of available capital.

The “per issuer” investment limitations proposed in the SEC Report will negatively impact entrepreneurs and small business owners relying upon the registration exemption in the NC PACES Act because a number of current accredited investors will be subject to investment limitations if the revised financial thresholds are adopted.<sup>124</sup> If “per issuer” investment limitations are imposed on certain accredited investors, many issuers relying on the NC PACES Act will have to “solicit a greater number of investors or [] solicit additional accredited investors, which could impose additional costs on those issuers or limit

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117. SEC. & EXCH. COMM’N, *supra* note 3, at 90.

118. 17 C.F.R. § 227.100(a)(2)(ii) (2016).

119. *Id.*; *see also* Crowdfunding, 80 Fed. Reg. at 71,393–71,394.

120. Crowdfunding, 80 Fed. Reg. at 71,394.

121. 17 C.F.R. § 230.251(d)(2)(i)(C).

122. *Id.*

123. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,805, 21,877 (Apr. 20, 2015).

124. SEC. & EXCH. COMM’N, *supra* note 3, at 90–91.

capital formation if they are unable to attract additional investors.”<sup>125</sup> Investment limitations are particularly problematic in the intrastate crowdfunding context, especially in states like North Carolina where the average income is lower than the national average,<sup>126</sup> because issuers relying on an intrastate crowdfunding exemption may only sell securities to residents of their state.<sup>127</sup> Investment limitations will restrict the amount of capital that can be invested by certain accredited investors, but “per issuer” investment limitations are unlikely to increase compliance costs for issuers in a significant way because issuers will simply need to calculate 10% of either the investor’s income or net worth when the issuer verifies an investor’s status as an accredited investor.

*B. Alternative Measures of Sophistication*

The recommendations from the SEC report pertaining to the financial thresholds are generally not concerned with expanding the pool of accredited investors because the financial thresholds are designed to ensure that accredited investors are capable of sustaining a loss of their investment. The recommendations in the SEC Report concerning alternative measures of financial sophistication are designed to expand the pool of accredited investors and make it easier for small businesses and entrepreneurs to raise capital. While the recommended investment limitations will negatively impact a significant number of current accredited investors, the investment limitations will positively impact sophisticated investors who do not currently qualify as accredited investors.<sup>128</sup> The current definition excludes an arguably non-negligible number of financially sophisticated individuals who, despite their knowledge and professional experience, do not qualify under the current definition because they do not meet the current financial thresholds.<sup>129</sup>

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125. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. at 21,877.

126. Burton, *supra* note 81.

127. 17 C.F.R. § 230.147(d) (2016).

128. See SEC. & EXCH. COMM’N, *supra* note 3, at 103–04.

129. Comment Letter from CrowdFund Intermediary Regulatory Advocates to Mary Jo White, Chair, Sec. & Exch. Comm’n (Jan. 14, 2016), <https://www.sec.gov/comments/4-692/4692-6.pdf> (“For example, a young investment broker who does not make \$200,000 per

### 1. Minimum Investments Test

The SEC Report recommends adding an alternative \$750,000 minimum investments test to the accredited investor definition.<sup>130</sup> The SEC's rationale for adding a minimum investments test is that a certain amount of investments may be a better indicator of "individuals' experience with and exposure to the financial and investing markets than income or net worth."<sup>131</sup> This recommendation has received less attention from commentators because many of the individuals and households who would qualify under the minimum investments test already qualify under the other financial thresholds.<sup>132</sup> In fact, the Report estimates that 10.3 million households would qualify under the minimum investments test, but only 1.65 million of those households would not otherwise qualify under the existing definition.<sup>133</sup>

The addition of 1.65 million new households to the accredited investor pool is welcome news for issuers and investors relying on the NC PACES Act, but it is unclear how many of these new accredited investors will be able to invest under the NC PACES Act. Because the NC PACES Act requires investors to be residents of North Carolina, this change would have a disproportionately lesser positive impact than other proposals that seek to expand the pool of accredited investors.<sup>134</sup>

### 2. Individuals with Professional Credentials, Individuals with Experience Investing in Exempt Offerings, and Individuals who Pass an Examination

The SEC Report's final recommendations discuss expanding the accredited investor definition to include individuals who have certain

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year nor has accumulated a million dollars of net worth, but has passed his or her Series 7, or 62 or 82 is able to sell Regulation D offerings to his or her clients, but is restricted from buying them for his or her own personal accounts.").

130. SEC. & EXCH. COMM'N, *supra* note 3, at 94 n.326.

131. SEC. & EXCH. COMM'N, *supra* note 3, at 94.

132. SEC. & EXCH. COMM'N, *supra* note 3, at 102–103.

133. SEC. & EXCH. COMM'N, *supra* note 3, at 103.

134. Issuers relying on the NC PACES Act must comply with Rule 147, which requires that "offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident." 17 C.F.R. § 230.147(d) (2016). "The transaction meets the requirements of the federal exemption for intrastate offerings in section 3(a)(11) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(11), and/or SEC rule 147, 17 C.F.R. § 230.147." N.C. GEN. STAT. § 78A-17.1(a)(2) (2016).

professional credentials, experience investing in private offerings, or have passed an examination.<sup>135</sup> The SEC Report discusses allowing individuals with certain educational or professional credentials, such as certified public accountants, chartered financial analysts, certified financial planners, investment advisor representatives, or broker-dealer registered representatives, to qualify as accredited investors even if they do not meet the financial thresholds.<sup>136</sup> The SEC Report seems to indicate that the SEC is unlikely to allow individuals to qualify as accredited investors solely based on educational or professional credentials because it would be difficult to determine which credentials would accurately determine an individual's financial sophistication.<sup>137</sup> In addition, individuals who possess certain credentials may no longer be employed or involved in the financial services industry.<sup>138</sup>

The SEC Report also discusses allowing individuals, who do not qualify as accredited investors under the financial thresholds, to pass an examination to qualify as accredited investors.<sup>139</sup> An accredited investor examination may be based upon existing examinations, such as the Series 7 and Series 82 examinations, but the SEC Report is clear that any accredited investor examination would take time to develop and is unlikely to be adopted in the near future.<sup>140</sup> The individuals who may be included under the educational, professional, or examination standards will likely expand the pool of accredited investors, but these new accredited investors will likely be subject to the investment limitations described above because of their lesser ability to sustain a loss of their investment.<sup>141</sup>

The expansion of the accredited investor pool, through the inclusion of financially sophisticated individuals, who do not meet the current thresholds, will provide issuers with greater access to investors who are authorized to invest more than \$5,000 in an offering conducted

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135. SEC. & EXCH. COMM'N, *supra* note 3, at 94–96.

136. SEC. & EXCH. COMM'N, *supra* note 3, at 58–59.

137. SEC. & EXCH. COMM'N, *supra* note 3, at 58–59.

138. *See* SEC. & EXCH. COMM'N, *supra* note 3, at 59, 61 (noting, however, that credentials might serve as an accurate proxy for financial sophistication with respect to those individuals who maintain active certifications or designations).

139. SEC. & EXCH. COMM'N, *supra* note 3, at 65–67.

140. SEC. & EXCH. COMM'N, *supra* note 3, at 66–67.

141. Comment Letter from Judith Shaw, Pres., N. Am. Sec. Adm'r Ass'n, Inc. (May 25, 2016), <https://www.sec.gov/comments/4-692/4692-34.pdf>.

pursuant to the NC PACES Act.<sup>142</sup> Individuals qualifying under the recommended alternative measures of sophistication will be allowed to invest 10% of their income or net worth, which may substantially increase the amount of capital that they can invest under the NC PACES Act.<sup>143</sup>

The inclusion of financially sophisticated individuals, who do not meet the current financial thresholds, will expand the pool of accredited investors, but issuers under the NC PACES Act may also face increased compliance costs as a result of these new accredited investors, which would effectively negate the potential benefits of a marginally larger accredited investor pool.<sup>144</sup> The investment limitations will likely impose higher compliance costs on issuers because they will have to obtain more information from investors in order to ensure that the investors are permitted to make certain investments.<sup>145</sup> The costs associated with verifying accredited investors will likely increase, but the North Carolina Secretary of State may mitigate these costs by promulgating rules which outline a clear standard for investor verification and set forth specific safe harbor methods of verification that issuers can take to ensure that the verification standard is satisfied.<sup>146</sup>

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142. N.C. GEN STAT. § 78A-17.1(a)(4) (2016) (permitting accredited investors to invest more than \$5,000 per offering); SEC. & EXCH. COMM'N, *supra* note 3, at 104 (“[T]he net effect of these non-quantifiable approaches would be to increase the size of the accredited investor pool.”).

143. If the “lesser of” approach used in Regulation Crowdfunding is adopted, a financially sophisticated individual with an income of \$100,000 and a net worth of \$500,000 will be permitted to invest up to \$10,000 instead of \$5,000. 17 C.F.R. § 227.100(a)(2)(ii) (2016). If the “greater of” approach used in Regulation A is adopted, a financially sophisticated individual with an income of \$100,000 and a net worth of \$500,000 will be permitted to invest up to \$50,000 instead of \$5,000. 17 C.F.R. § 230.251(d)(2)(i)(C) (2016).

144. Comment Letter from Todd McCracken, Nat'l Small Bus. Ass'n 2 (Mar. 29, 2016), <https://www.sec.gov/comments/4-692/4692-18.pdf> (explaining that investment limitations “could introduce new levels of complexity into verifying an accredited investor’s status and would increase the cost of raising money for small businesses.”).

145. Susan Burke & David Diamond, *Issues Surrounding Verification of Accredited Investor Status Under Proposed Rule 506(c)* (Oct. 2012), <http://www.pedersenhoupt.com/newsroom-alerts-Proposed-Rule-506c.html>.

146. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,801 (Jul. 24, 2013) (“Our decision to provide a non-exclusive list of specified methods that issuers can use to verify a purchaser’s accredited investor status will provide legal certainty in those circumstances in which there is a question as to whether or not the steps taken are reasonable in light of the facts and circumstances. Using a specified method would reduce issuers’ verification costs to the extent that they would otherwise incur costs to analyze whether or not the steps they

## IV. DIFFERENT APPROACHES TO ACCREDITED INVESTOR VERIFICATION

The possible changes to the accredited investor definition represent a challenge and a great opportunity to issuers and investors relying on the NC PACES Act. Some of the possible changes, specifically the investment limitations, will likely increase the complexity of raising capital from accredited investors under the NC PACES Act since issuers, in order to maximize the benefits of the Act, will need to raise capital from accredited investors and non-accredited investors.<sup>147</sup> As discussed above, the NC PACES Act forbids issuers from raising more than \$5,000 from an investor unless the investor qualifies as an accredited investor under Rule 501.<sup>148</sup> The Act further requires that issuers raising funds through a website must “obtain from each purchaser of a security under this section evidence that the purchaser is a resident of North Carolina and, if applicable, an accredited investor.”<sup>149</sup> The increased uncertainty surrounding the verification of accredited investors due to investment limits on certain accredited investors could jeopardize the viability of the NC PACES Act as a means of raising capital for small businesses and entrepreneurs in North Carolina.

The NC PACES Act authorizes the North Carolina Department of the Secretary of State (“the Secretary”) to implement the statute and grants the Secretary authority to “adopt rules and issue orders that are necessary or appropriate in the public interest or for the protection of investors.”<sup>150</sup> The Secretary began the rulemaking process in August 2016 and released proposed rules on January 31, 2017.<sup>151</sup> The proposed

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had taken or proposed to take satisfied the reasonableness standard in Rule 506(c).”).

147. *NC PACES Act of 2016, North Carolina’s Intrastate Investment Crowdfunding Legislation Frequently Asked Questions – Key Features and Benefits* (Jul. 2016), <http://jobsnc.blogspot.com/p/faqs.html> [hereinafter *NC PACES FAQs*] (“By looking at the data from places where investment crowdfunding is already legal the data shows that most successful raises are accomplished through a combination of many small (\$1,000 to \$5,000) investments along with a few more substantial sums (\$25,000 to \$100,000).”).

148. N.C. GEN. STAT. § 78A-17.1(a)(4) (2016); 17 C.F.R. § 230.501 (2016).

149. N.C. GEN. STAT. § 78A-17.1(a)(9)(b) (2016).

150. N.C. GEN. STAT. § 78A-17.1(f). The Secretary of State is in the rulemaking process. N.C. DEP’T OF SEC’Y OF STATE, CROWDFUNDING (PACES ACT) RULEMAKING (Aug. 9, 2016), [https://www.sosnc.gov/legal/pdf/Website\\_Letter\\_8-9-16.1.pdf](https://www.sosnc.gov/legal/pdf/Website_Letter_8-9-16.1.pdf).

151. Invest NC Exemption (Crowdfunding), (proposed on Jan. 31, 2017) (to be codified at 18 N.C. ADMIN. CODE 06A § .2000–.2048), <http://sosnc.gov/legal/pdf/Proposed%20Rule%20Changes%201-31-17.pdf>.

rules fail to provide issuers with any meaningful guidance with respect to verification of investors.<sup>152</sup>

Under the proposed rules, an issuer must file a Notice of Intrastate Claim of Exemption Form (Form NCE) which, among other things, attests to the issuer's commitment to refrain from accepting more than \$5,000 from an investor "unless the issuer reasonably believes that the purchaser is an accredited investor."<sup>153</sup> In addition to filing Form NCE, issuers must obtain "a written, signed and dated declaration of the investor's North Carolina residency and, if applicable, accredited investor status" along with "evidence supporting the declaration."<sup>154</sup> The proposed rules fail to specify any specific documents or types of evidence that are sufficient to support an investor's declaration. Without specific safe harbor provisions, issuers cannot be certain that they have complied with the reasonable belief standard of verification. The possible changes to the accredited investor definition will exacerbate the uncertainty created by the proposed rules because verification of accredited investors will likely become more complicated.

If the Secretary reconsiders the proposed rules and promulgates clear and unambiguous regulations for verifying accredited investors, issuers relying on the NC PACES Act will likely benefit from the possible changes to the accredited investor definition that expand the definition because there will be more investors who are permitted to invest more than \$5,000 per offering.<sup>155</sup> The Secretary's power to minimize the negative impacts resulting from changes to the accredited investor definition are somewhat limited, due to the statutory nature of the NC PACES Act,<sup>156</sup> but the Secretary enjoys sufficient discretion to implement regulations designed to reduce the uncertainty surrounding

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152. *Id.*

153. Notice of Intrastate Claim of Exemption Form Requirements, (proposed on Jan. 31, 2017) (to be codified at 18 N.C. ADMIN. CODE 06A § .2005(1)(e)), <http://sosnc.gov/legal/pdf/Proposed%20Rule%20Changes%201-31-17.pdf>.

154. Issuer Shall Require Investor Actions, (proposed on Jan. 31, 2017) (to be codified at 18 N.C. ADMIN. CODE 06A § .2012(a)(2)), <http://sosnc.gov/legal/pdf/Proposed%20Rule%20Changes%201-31-17.pdf>.

155. SEC. & EXCH. COMM'N, *supra* note 3, at 106 (estimating that the recommended changes will increase the number of households qualifying as accredited investors from 12,400,000 to roughly 14,000,000).

156. The investment limitations in the NC PACES Act are unequivocally tied to the accredited investor definition "as defined by rule 501 of SEC regulation D, 17 C.F.R. § 230.501." N.C. GEN STAT. § 78A-17.1(a)(4) (2016).

the verification of accredited investors.<sup>157</sup> North Carolina has arguably suffered from the delay in implementing an intrastate crowdfunding exemption, but this delay has allowed the Secretary to observe the requirements for accredited investor verification utilized by the SEC and other states with intrastate crowdfunding exemptions.<sup>158</sup>

A. *Approaches to Verification Used by the SEC*

Regulation A, Regulation Crowdfunding, and Rule 506(c) all contain investment limitations and all require issuers to verify that their investors are in compliance with these investment limits. Since all three of these exemptions are significantly different, the SEC utilizes different standards of investor verification for each registration exemption.

1. Regulation A

The investment limitations in Regulation A are limited in scope and the verification requirement is relatively lenient. Non-accredited investors participating in Tier II offerings are limited to investing 10% of their annual income or net worth, whichever is greater.<sup>159</sup> Additionally, the investment limitations do not apply when the securities purchased by an investor will be “listed on a registered national securities exchange upon qualification.”<sup>160</sup> Non-accredited

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157. The NC PACES Act authorizes the N.C. Secretary of State to “adopt rules and issue orders that are necessary or appropriate in the public interest or for the protection of investors.” N.C. GEN STAT. § 78A-17.1(f). Issuing rules to clarify the verification process for accredited investors under the NC PACES Act is in the public interest because it will provide certainty to issuers and assist them in raising capital. In addition to assisting issuers, rules clarifying the verification of accredited investors under the NC PACES Act will protect investors by ensuring that investors are thoroughly verified before they are permitted to invest more than \$5,000 in an offering.

158. *See, e.g.*, ALA. CODE § 8-6-11(a)(14); ALASKA STAT. § 45.55.175(a); ARIZ. REV. STAT. ANN. § 44-1844(D); COLO. REV. STAT. § 11-51-308.5; DEL. CODE ANN. tit. 6, § 73-207; FLA. STAT. § 517.0611; GA. COMP. R. & REGS. 590-4-2.08; IDAHO CODE §§ 30-14-203; 815 ILL. COMP. STAT. 5/2.34; IOWA CODE § 502.202(24); IND. CODE § 23-19-2-2; KAN. ADMIN. REGS. § 81-5-21; KY. REV. STAT. ANN. § 292.411; ME. STAT. tit. 32 § 16304; 950 MASS. CODE REGS. 14.402; MICH. COMP. LAWS ANN. § 451.2202; MINN. STAT. § 80A.461; MONT. CODE ANN. § 30-10-105; NEB. REV. STAT. § 8-1111; S.C. CODE REGS. § 13-206; TENN. CODE ANN. § 48-1-103; 7 TEX. ADMIN. CODE § 139.25; 4-4 VT. CODE R. § 8; VA. CODE ANN. § 13.1-514; WIS. STAT. § 551.202. *Contra* MD. CODE ANN. CORPS. & ASS’NS § 11-601.

159. 17 C.F.R. § 230.251(d)(2)(i)(C) (2016).

160. *Id.*; *see* Amendments for Small and Additional Issues Exemptions Under the

investors, who are subject to investment limitations, are authorized to self-certify compliance with the investment limitations, and issuers are permitted to rely upon this certification unless the dealer, at the time of the sale, knows that it is untrue.<sup>161</sup>

The SEC noted that a self-certification standard for investor verification was appropriate for Regulation A offerings, in part, because of “the total package of investor protections included in the final rules for Tier II offerings.”<sup>162</sup> These protections include “limitations on issuer eligibility, bad actor disqualification provisions, a requirement that offering statements must be qualified by the [SEC], narrative and financial disclosure requirements, which for Tier II offerings must include audited financial statements on an initial and annual basis, as well as annual, semiannual, and current eventreporting.”<sup>163</sup>

Issuers under the NC PACES Act may prefer a self-certification standard for investor verification because of “the privacy issues and practical difficulties associated with verifying individual income and net worth.”<sup>164</sup> However, a self-certification standard is inconsistent with the statutory language of the NC PACES Act, which requires issuers to “obtain from each purchaser of a security under this section evidence that the purchaser is a resident of North Carolina and, if applicable, an accredited investor.”<sup>165</sup>

## 2. Regulation Crowdfunding

The SEC applies a slightly more stringent approach under Regulation Crowdfunding than the self-certification standard used in Regulation A. In Regulation Crowdfunding, unlike Regulation A, the investment limitations apply to all investors.<sup>166</sup> The investment limitations in Regulation Crowdfunding divide investors into two

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Securities Act (Regulation A), 80 Fed. Reg. 21,805, 21,877 (Apr. 20, 2015) (“[T]he final rules exclude sales of securities that will be listed on a national securities exchange upon qualification from Tier 2 investment limitations.”).

161. 17 C.F.R. § 230.251(d)(2)(i)(D).

162. Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), 80 Fed. Reg. at 21,817.

163. *Id.* at 21817 n.157.

164. Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), at 80 Fed. Reg. at 21,817.

165. N.C. GEN. STAT. § 78A-17.1(a)(9)(b) (2016).

166. 17 C.F.R. § 227.100(a)(2) (2016).

groups based on whether or not an investor has an income of \$100,000 per year and a net worth of \$100,000.<sup>167</sup> If either an investor's net worth or annual income is below \$100,000, the investor is limited to investing "[t]he greater of \$2,000 or 5[%] of the lesser of the investor's annual income or net worth."<sup>168</sup>

Due to the complex nature of the investment limitations in Regulation Crowdfunding, the SEC allows issuers to rely on an intermediary to verify the compliance of investors with the investment limitations, "provided that the issuer does not know that the investor has exceeded the investor limits or would exceed the investor limits as a result of purchasing securities in the issuer's offering."<sup>169</sup> Although the verification standard seems somewhat lenient and less demanding for issuers since issuers are permitted to rely on intermediaries to verify investors, issuers utilizing Regulation Crowdfunding, unlike investors under the NC PACES Act,<sup>170</sup> are required to exclusively use a registered intermediary to conduct an offering.<sup>171</sup>

The Secretary should not adopt a verification standard that is identical to the one from Regulation Crowdfunding because it would effectively require issuers to use an intermediary, which would eliminate some of the flexibility that the NC PACES Act affords issuers.<sup>172</sup>

### 3. Regulation 506(c)

When the SEC adopted Rule 506(c), it also implemented a new standard of investor verification that requires issuers to "take reasonable steps to verify" that all purchasers are accredited investors.<sup>173</sup> This verification standard was statutorily mandated and, according to the SEC, necessary to alleviate worries "that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors."<sup>174</sup>

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167. *Id.*

168. *Id.*

169. Instruction 3 to paragraph (a)(2) of § 227.100(a)(2).

170. N.C. GEN. STAT. § 78A-17.1(a)(9) (2016).

171. 17 C.F.R. § 227.100(a)(3).

172. N.C. GEN. STAT. § 78A-17.1(a)(9).

173. 17 C.F.R. § 230.506(c)(2).

174. Eliminating the Prohibition Against General Solicitation and General Advertising

The SEC has stated that the reasonableness of the steps taken to verify an accredited investor is “an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction.”<sup>175</sup> In adopting a principles-based approach to accredited investor verification, the SEC set forth a number of factors for issuers to consider when verifying purchasers.<sup>176</sup>

After receiving negative feedback on the uncertainty naturally created by a principles-based approach, the SEC set forth a non-exclusive list of verification methods that issuers may use to automatically satisfy the “reasonable steps” requirement.<sup>177</sup> Specifically, Issuers may satisfy the verification requirement based on income by “reviewing any Internal Revenue Service form that reports the purchaser’s income for the two most recent years . . . and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.”<sup>178</sup> Issuers may satisfy the verification requirement based on net worth by reviewing one of a number of specified financial documents<sup>179</sup> that is no older than three months, which identifies the purchaser’s assets and liabilities, and a “written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed.”<sup>180</sup> Issuers may also satisfy the verification requirement, based on either a purchaser’s income or net worth, by relying on written confirmation from a registered broker-dealer, an SEC-registered investment advisor,

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in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,776 (Jul. 24, 2013).

175. *Id.*

176. *Id.* (“The nature of the purchaser and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; and the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.”).

177. *Id.* at 44781.

178. 17 C.F.R. § 230.506(c)(2)(ii)(A).

179. Issuers may verify a purchaser’s assets by reviewing “[b]ank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties.” 17 C.F.R. § 230.506(c)(2)(ii)(B)(1). Issuers may verify a purchaser’s liabilities by reviewing “[a] consumer report from at least one of the nationwide consumer reporting agencies.” § 230.506(c)(2)(ii)(B)(2).

180. 17 C.F.R. § 230.506(c)(2)(ii)(B).

an attorney, or a CPA that the purchaser qualifies as an accredited investor.<sup>181</sup>

The investor verification standard in Rule 506(c) is more stringent, and thus more costly, than the verification standards in Regulation A and Regulation Crowdfunding, but the standard in Rule 506(c) provides greater protections for investors at a reasonable cost to issuers.<sup>182</sup>

*B. Verification Approaches Used in States with Intrastate Crowdfunding Exemptions*

1. Virginia

In 2015, the Virginia legislature enacted an intrastate crowdfunding statute<sup>183</sup> and the State Corporation Committee promulgated regulations implementing the statute.<sup>184</sup> Under the Virginia intrastate exemption, an issuer may raise up to \$2,000,000 per year<sup>185</sup> from accredited investors and non-accredited investors.<sup>186</sup> Non-accredited investors are limited to investing \$10,000 per issuer.<sup>187</sup> Issuers bear the burden of proving that they have complied with a registration exemption, but neither the statute nor the regulations provide explicit guidance regarding the requirements for accredited investor verification.<sup>188</sup> While the statute and regulations are silent on the verification requirements, the State Corporation Committee has indicated that investors relying upon the Virginia Crowdfunding Exemption are permitted to self-certify their status as accredited investors.<sup>189</sup>

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181. 17 C.F.R. § 230.506(c)(2)(ii)(C). The specified third parties must represent to an issuer that the third party took reasonable steps within the prior three months to verify that a purchaser qualifies as an accredited investor. *Id.*

182. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,801 (Jul. 24, 2013).

183. VA. CODE ANN. § 13.1-514(B)(21) (2016).

184. 21 VA. ADMIN. CODE § 5-40-190 (2016).

185. 21 VA. ADMIN. CODE § 5-40-190(A)(4).

186. 21 VA. ADMIN. CODE § 5-40-190(A)(5).

187. 21 VA. ADMIN. CODE § 5-40-190(A)(4).

188. VA. CODE ANN. § 13.1-514(C) (2016); 21 VA. ADMIN. CODE § 5-40-190 (2016).

189. VIRGINIA INTRASTATE CROWDFUNDING EXEMPTION AND REGULATION A COMPARISON, VA. STATE CORP. COMM'N (Mar. 2016), [https://www.scc.virginia.gov/srf/bus/regA\\_crowd.pdf](https://www.scc.virginia.gov/srf/bus/regA_crowd.pdf).

The self-certification standard seemingly permitted under the Virginia exemption, much like the verification standard in Regulation A, may be preferable for issuers under the NC PACES Act,<sup>190</sup> but this standard appears to be inconsistent with the statutory language of the NC PACES Act.<sup>191</sup>

## 2. Texas

The Texas State Securities Board implemented an intrastate crowdfunding exemption in 2014.<sup>192</sup> Issuers relying on the Texas exemption are permitted to raise a maximum of \$1,000,000 per year.<sup>193</sup> Non-accredited investors are authorized to invest a maximum of \$5,000 per issuer, per year, while accredited investors are not subject to investment limitations.<sup>194</sup> The Texas exemption, unlike the Virginia exemption and the NC PACES Act, requires that all offerings be conducted “through an Internet website operated by a registered general dealer or registered Texas crowdfunding portal.”<sup>195</sup>

The Texas exemption also imposes a slightly different verification standard than the one utilized by the Virginia exemption.<sup>196</sup> Investors are permitted to self-certify their status as accredited investors,<sup>197</sup> but issuers are required to have a reasonable basis for believing that those claiming to be accredited investors are in fact accredited investors.<sup>198</sup> Issuers may verify accredited investors through

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190. Issuers under the NC PACES Act may prefer a self-certification standard for investor verification because of “the privacy issues and practical difficulties associated with verifying individual income and net worth.” Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), 80 Fed. Reg. at 21,817.

191. N.C. GEN. STAT. § 78A-17.1(a)(9)(b) (2016) (“The issuer shall obtain from each purchaser of a security under this section evidence that the purchaser is a resident of North Carolina and, if applicable, an accredited investor.”).

192. 7 TEX. ADMIN. CODE § 139.25 (2016).

193. 7 TEX. ADMIN. CODE § 139.25(d).

194. 7 TEX. ADMIN. CODE § 139.25(e).

195. 7 TEX. ADMIN. CODE § 139.25(d).

196. 7 TEX. ADMIN. CODE § 139.25(e).

197. *Information for Issuers Using Crowdfunding*, TX. STATE SEC. BD. (Oct. 20, 2016) (“A purchaser can self-certify accredited status. This can be accomplished by having the prospective purchaser provide information that confirms the status, such as by identifying the accreditation category applicable to the purchaser.”), <https://www.ssb.texas.gov/texas-securities-act-board-rules/texas-intrastate-crowdfunding/information-issuers-using#accredited-investors>.

198. *Id.*

a financial questionnaire, and most significantly, it is not considered reasonable for an issuer to verify an accredited investor's status through a simple "yes" or "no" question.<sup>199</sup> The Texas State Securities Board has also indicated that issuers may rely upon third parties to verify the status of accredited investors, but issuers must still inquire about a third-party's methods of verification to ensure that they are reasonable.<sup>200</sup>

The investor verification standard used by the Texas intrastate crowdfunding exemption provides more protection for investors than a self-certification standard, but the regulations implementing the exemption do not provide issuers with the same amount of clarity and certainty that the SEC provides in Rule 506(c).<sup>201</sup>

## V. RECOMMENDATIONS AND CONCLUSION

The Secretary cannot promulgate rules that would completely shield investors and issuers relying on the NC PACES Act from the negative impacts of increased financial thresholds in the accredited investor definition because the NC PACES Act incorporates the definition from Rule 501.<sup>202</sup> Steps can be taken, however, to minimize the uncertainty imposed by these changes on issuers.<sup>203</sup> Furthermore, the Secretary's proposed rules do not provide adequate guidance to issuers or adequate protections to investors with respect to the verification of accredited investors.<sup>204</sup>

The Secretary's rule regarding the verification of accredited investors must be clear and unambiguous because issuers may expose themselves to liability by receiving more than \$5,000 from investors who are not properly verified as accredited investors.<sup>205</sup> Issuers must

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199. *Id.*

200. *Id.*

201. 17 C.F.R. § 230.506(c).

202. N.C. GEN STAT. § 78A-17.1 (2016).

203. *Id.*

204. *See* Issuer Shall Require Investor Actions, (proposed on Jan. 31, 2017) (to be codified at 18 N.C. ADMIN. CODE 06A § .2012(a)(2)), <http://sosnc.gov/legal/pdf/Proposed%20Rule%20Changes%201-31-17.pdf>.

205. *See* N.C. GEN STAT. § 78A-24. Any issuer that sells unregistered securities while not qualifying for a registration exemption "is liable to the person purchasing the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at the legal rate from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security." N.C. GEN STAT. § 78A-56(a)(1).

comply with all of the requirements in the Act in order to qualify for the exemption.<sup>206</sup> The Act contains straightforward standards regarding the amount of capital that an issuer can raise from investors who are not accredited investors.<sup>207</sup> If an issuer receives more than \$5,000 from a non-accredited investor, it will not be in compliance with the Act, ineligible for the exemption, and in violation of the securities registration requirements under North Carolina law.<sup>208</sup>

The Secretary should adopt a principles-based approach to the verification of accredited investors, which closely resembles the approach used by the SEC in Rule 506(c) offerings.<sup>209</sup> In addition to the safe harbor provisions found in 506(c),<sup>210</sup> the Secretary should include in the regulation an additional safe harbor provision for reliance on certain third-party verification services not included in the existing safe harbor provisions.<sup>211</sup> Rule 506(c) allows issuers to satisfy the verification requirement by relying upon a written report from certain professionals certifying that investors are in fact accredited investors.<sup>212</sup>

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206. N.C. GEN STAT. § 78A-17.1(a).

207. N.C. GEN STAT. § 78A-17.1(a)(9)(b).

208. N.C. GEN STAT. § 78A-24 (2016).

209. 17 C.F.R. § 230.506(c). Rule 506(c) contains three safe harbor provisions. If an issuer does not have knowledge that a purchaser is not an accredited investor, it will be assumed that the issuer took reasonable steps to verify a purchaser's status as an accredited investor if the issuer (1) "review[s] any Internal Revenue Service form that reports the purchaser's income for the two most recent years . . . and obtain[s] a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year," (2) "review[s] [certain enumerated financial documents listing assets and liabilities] dated within the prior three months and obtain[s] a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed," or (3) "[o]btain[s] a written confirmation from [certain persons or entities] that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor." 17 C.F.R. § 230.506(c)(2)(ii)(A)–(C). Individuals that drafted and promoted the NC PACES Act have compared the registration exemption in the NC PACES Act to the exemption in Rule 506(c). *NC PACES FAQs*, *supra* note 147.

210. 17 C.F.R. § 230.506(c)(2)(ii)(A)–(C).

211. See DAVID STOCKTON, KILPATRICK TOWNSEND & STOCKTON LLP, *RULE 506(C) AND THE FUTURE OF PRIVATE PLACEMENT PRACTICES* (Aug. 2, 2013), <http://www.kilpatricktownsend.com/~media/Files/articles/2013/StocktonLaw360Rule506cAndTheFutureOfPrivatePlacementPractices.ashx>.

212. These include "(1) A registered broker-dealer; (2) An investment adviser registered with the Securities and Exchange Commission; (3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or (4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office." 17 C.F.R. § 230.506(c)(2)(ii)(C) (2016).

The SEC has indicated that issuers may use other third parties to verify accredited investors, but these services do not qualify under the existing safe harbor provision in Rule 506(c).<sup>213</sup>

The strongest criticism of this approach to accredited investor verification is that it will unreasonably increase compliance costs for issuers.<sup>214</sup> An additional safe-harbor method of verification, which can be utilized at a relatively small cost to issuers, would alleviate some of these concerns.<sup>215</sup> The SEC has indicated that the safe-harbor provisions were designed to “provide legal certainty in those circumstances in which there is a question as to whether or not the steps taken are reasonable in light of the facts and circumstances.”<sup>216</sup> The legal certainty provided by the safe harbors also “reduce[s] issuers’ verification costs to the extent that they would otherwise incur costs to analyze whether or not the steps they had taken or proposed to take satisfied the reasonableness standard in Rule 506(c).”<sup>217</sup> If the Secretary adopts the suggested regulation, issuers in North Carolina could benefit from using third-party services from across the country because the North Carolina standard would be identical to the verification standards for Rule 506(c).

An approach to accredited investor verification similar to the one used in Rule 506(c), with an additional safe-harbor provision for certain professional third-party verification services, will also benefit accredited investors under the NC PACES Act. The typical issuer conducting an offering pursuant to the NC PACES Act will be a small business or an entrepreneur, which means that accredited investors may be uncomfortable providing sensitive personal and financial information when these issuers have little experience handling these types of

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213. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,781 (Jul. 24, 2013).

214. See e.g., JEREMY D. GLASER, *The Downside of SEC’s New General Solicitation Rules*, LAW360 (Nov. 7, 2013, 4:00 PM), <https://www.law360.com/articles/487062/the-downside-of-sec-s-new-general-solicitation-rules>.

215. Since the SEC issued the new requirements for investor verification under Rule 506(c), a number of entities have begun offering accredited investor verification services for \$49 to \$69 per investor. VERIFYINVESTOR.COM, <https://verifyinvestor.com> (last visited Jan. 5, 2017); EARLY IQ, INC., <https://www.earlyiq.com/accredited-investor-verification> (last visited Jan. 5, 2017).

216. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,801 (Jul. 24, 2013).

217. *Id.*

documents.<sup>218</sup> In fact, the NC PACES Act has been promoted as being easier and more convenient for issuers than Regulation Crowdfunding, in part, because the Act was designed to avoid “situation[s] where startup companies are forced to handle highly sensitive financial information of potential investors in order to ensure that they do not lose their exemption.”<sup>219</sup>

Given that the NC PACES Act uses the accredited investor definition as the standard for implementing investment limitations, changes to the accredited investor definition will impact the intrastate crowdfunding market in North Carolina.<sup>220</sup> The Secretary may help preserve the capital raising advantages provided in the NC PACES Act by promulgating clear and concise regulations concerning the verification of accredited investors. Adding an additional safe-harbor provision or expanding the current safe harbor provision under Rule 506(c) for third-party verification would adequately protect investors, while providing clarity and certainty to issuers, which will foster more confidence in the NC PACES Act. On the other hand, if the Secretary fails to adopt clear and concise standards regarding the verification of accredited investors, potential issuers may avoid raising capital under the NC PACES Act because of the increased uncertainty.

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218. Comment Letter from Brett Palmer, President, Small Business Investor Alliance, to Elizabeth M. Murphy, Sec’y, Sec. & Exch. Comm’n (Oct. 5, 2012), <https://www.sec.gov/comments/s7-07-12/s70712-132.pdf>.

219. *NC PACES FAQs*, *supra* note 147.

220. N.C. GEN STAT. § 78A-17.1(a)(4) (2016).

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