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SEC Advisory Committee On Small And Emerging Companies’  
Recommendations On Accredited Investor Definition

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On December 17, 2014 and again on March 4, 2015, the SEC Advisory Committee on Small and Emerging Companies (the “Advisory Committee”) met and finalized its recommendation to the SEC regarding the definition of “accredited investor.” The Advisory Committee unanimously approved the recommendation, which is decidedly pro small business and supportive of facilitating capital formation, and communicated such recommendation to the SEC in a letter dated March 9, 2015 (the “Letter”). The Letter contains a pragmatic discussion of the importance of small business capital formation, the importance of the “accredited investor” definition, and the lack of connection between the definition and fraud prevention.

As set forth in the Advisory Committee Letter, the committee was organized by the SEC to provide advice on SEC rules, regulations and policies regarding “its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation” as related to “(i) capital raising by emerging privately held small businesses and publicly traded companies with less than \$250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject.”

The Advisory Committee made four recommendations related to the definition of “accredited investor,” each of which I support fully. In particular:

(1) That if any change is made to the definition of “accredited investor,” such change should “have the effect of expanding, not contracting, the pool of accredited investors.” For example, they recommended that the definition include investors that satisfy a sophistication test that is not tied into income or net worth. In addition, the

Advisory Committee recommended that that tax treatment of assets be excluded from any net worth calculation.

(2) That the SEC takes into account the effect of inflation and adjust the accredited investor thresholds in accordance with the consumer price index.

(3) “Rather than attempting to protect investors by raising the accredited investor thresholds or excluding certain asset classes from the calculation to determine accredited investor... the Commission should focus on enhanced enforcement efforts and increased investor education” and

(4) The SEC should continue to gather data on the subject.

### **Advisory Committee Considerations in Support of Its Recommendations**

The Advisory Committee Letter lists practical facts and realities related to small business and emerging company capital formation in support of its recommendations. In particular:

- Smaller and emerging companies are “critical to the economic well-being of the United States,” generating the majority of net new jobs in the last five years and continuing to add more jobs;
- Rule 506 of Regulation D is the most widely used private offering exemption, resulting in \$1 trillion of raised capital in 2013;
- Most early-stage, venture capital and angel investments are made in reliance on Rule 506;
- Other than Rule 506(b), which allows up to 35 unaccredited investors (when certain disclosures and financial information are provided), all investors in Rule 506 offerings must be accredited;
- The Dodd-Frank Act requires the SEC to review the accredited investor definition to determine whether it “should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy.”
- There are groups and commentators that advocate increasing the thresholds in the accredited investor definition to prevent fraud against investors. However, the SEC is not of “any substantial evidence suggesting that the current definition of accredited investor has contributed to the ability of fraudsters to commit fraud or has resulted in greater exposure for potential victims.” In addition, “the connection between fraud and the current accredited investor thresholds seems tenuous at best.”

- Some groups and commentators advocate excluding “retirement assets” from the calculation of net worth. The Advisory Committee rightfully and logically points out that “retirement assets” refer to a tax treatment and not a class of assets, and can be anything from an IRA to racehorses, to bitcoins, to real estate and anything in between. Retirement assets are not classified based on risk and are not somehow risk-protected. Many of the most experienced, wealthiest investors have the majority of their portfolio in assets that receive “retirement assets” tax treatment, and there is no justification for excluding tax-protected accounts from the accredited definition.
- There is little or no evidence to suggest that the existing definition of accredited investor has led to widespread fraud or other harm to investors; rather, there is substantial evidence that the current definition works.

The Advisory Committee concludes that if the income and net worth thresholds are increased, it “will materially decrease the pool of capital available for smaller businesses.” It continues by stating that such a change “would have a disparate impact on those areas having a lower cost of living, which areas often coincide with regions of lower venture capital activity.” Finally, the Advisory Committee expressed concern that the impact would disproportionately affect women and minority entrepreneurs.

### **Refresher on Current Accredited Investor Definition**

An “Accredited investor” is defined as any person who comes within any of the following categories:

1. Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act, whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings

and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

2. Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
3. Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
4. Any 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;
5. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his or her purchase exceeds \$1,000,000, not including their principal residence;
6. Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
7. Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and
8. Any entity in which all of the equity owners are accredited investors.

## The Author

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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