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SEC Issues Report 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 18, 2015, the SEC issued a 118-page report on the definition of "Accredited Investor" (the "Report"). The report follows the March 2015 SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") recommendations related to the definition. The SEC is reviewing the definition of "accredited investor" as directed by the Dodd-Frank Act, which requires that the SEC review the definition as relates to "natural persons" every four years to determine if it should be modified or adjusted.

The definition of "accredited investor" has not been comprehensively re-examined by regulators since its adoption in 1982; however, in 2011 the Dodd-Frank Act amended the definition to exclude a person's primary residence from the net worth test of accreditation.

Although the Report contains detailed discussions on the various aspects of the definition of an accredited investor, the history of the different aspects of the definition, a discussion of different approaches taken in other U.S. regulations and in foreign jurisdictions and an in-depth discussion on the reasoning behind its recommendations, the actual recommendations are only conceptual and broad-based and do not contain specifics. Accordingly, we will need to wait for a future proposed rule release to see what, if any, of the recommendations will be implemented and to what degree. This blog provides a broad summary of the Report.

Background

All offers and sales of securities must either be registered with the SEC under the Securities Act of 1933 (the “Securities Act”) or be subject to an available exemption to registration. The ultimate purpose of registration is to provide investors and potential investors with full and fair disclosure to make an informed investment decision. The SEC does not pass on the merits of a particular deal or business model, only its disclosure. In setting up the registration and exemption requirements, Congress and the SEC recognize that not all investors need public registration protection and not all situations have a practical need for registration – thus the registration exemptions in Sections 3 and 4 of the Securities Act and the rules promulgated thereunder. Exempted offerings carry additional risks in that the level of required investor disclosure is much less than in a registered offering, the SEC does not review the offering documents, and there are no federal ongoing disclosure or reporting requirements.

Regulation D provides the most commonly used transactional exemptions to registration. The SEC notes in its Report that $1.3 trillion was raised under Regulation D in 2014 alone. The definition of “accredited investor” provides the backbone to the Regulation D exemptions and is “intended to encompass those 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.”

In addition to investor protection, the SEC also has a mandate to assist businesses with capital formation and the definition of “accredited investor” must walk the line between these goals. An overly restrictive definition will damage the ability of businesses to access private capital, and an overly broad definition would be contrary to the SEC’s investor protection goals.

Qualifying as an accredited investor makes the difference between being able to participate in an exempt offering or not, and the ability for an issuer to rely on an exemption or not, and accordingly is a very important component of the securities regulations. For example, some exemptions like Rule 506(c) are limited to accredited investors only. Rules 505 and 506(b) limit offers and sales to no more than 35 unaccredited investors. Many state law exemptions limit offers and sales of securities based on the status of an investor as accredited or not.

An issuer's required disclosure is also tied into whether investors and potential investors are accredited. For example, under Rules 505 and 506(b) issuers must provide certain delineated financial and non-financial disclosures if an offering will be made to any non-accredited investors.

The Current Definition of "Accredited Investor"

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

- 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;

- Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
- 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;
- 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;
- 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;
- 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;
- 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
- Any entity in which all of the equity owners are accredited investors.

The SEC Report discusses the different approaches and their respective histories. The Report also considers the approach taken by different countries including Australia, Canada, the EU, Israel, Singapore and the United Kingdom. The SEC considered these different approaches in making its recommendations. Although a synopsis of these discussions is beyond the scope of this blog, it does provide for interesting reading and insight into the regulatory regime.

SEC Recommendations Related to the Accredited Investor Definition

The Report considered numerous different approaches and potential changes and contains discussion supporting each element in determining an accredited investor and the recommended changes. The Report discusses the numerous different proposals considered, the input of commenters, the challenges that will be associated with each of its recommendations and the reasoning behind such recommendations. However, notably absent from the Report are specific recommendations associated with the broad concepts.

The SEC staff recommends a complete revision to the definition of accredited investor and in particular makes the following recommendations:

- Leave the current income and net worth thresholds in place, subject to investment limitations;
- Create new, additional inflation-adjusted income and net worth thresholds that are not subject to investment limitations;
- Index all financial thresholds for inflation on a going-forward basis;
- Permit spousal equivalents to pool their finances for purposes of qualifying as accredited investors;
- Add a new qualification for individuals based on measures of sophistication including parameters considering the person's (i) amount of investments; (ii) professional credentials; (iii) experience investing in exempt offerings; and (iv) status as a knowledgeable employee of a private fund for investments in the employer's fund. In addition, the SEC recommends permitting individuals who pass an accredited investor examination to qualify as an accredited investor.
- Revise the definition as it applies to entities by replacing the $5 million assets test with a $5 million investments test and including all entities rather than the specifically enumerated types of entities; and
- Grandfather issuers' existing investors that are accredited investors under the current definition with respect to future offerings of their securities.

Legal & Compliance, LLC
330 Clematis Street, West Palm Beach, FL 33401
Local: 561-514-0936 Toll-Free: 800-341-2681
LAnthony@LegalAndCompliance.com
www.LegalAndCompliance.com
www.SecuritiesLawBlog.com
www.LawCast.com

I agree with each of the proposed conceptual changes and in particular the addition of the sophistication qualifications; however, until actual proposals are made that include specifics, such as the specific investment limitations, specific criteria to establish sophistication and specific proposed adjustments, I remain as unspecific in my opinion as the SEC is in its recommendations!

Leaving a strict bright line financial test, without the additional sophistication test, is too restrictive to meet the goal of assisting businesses in accessing capital. According to the SEC Report, in 2013, only 10.1% of U.S. households qualified as accredited investors and adjusting the financial tests for inflation will drop that percent to 3.6%.

The SEC staff points out that there is currently no definition of the term “income” and very limited guidance on the matter. The recommendations do not offer further guidance or suggest any changes. From a practitioner’s perspective, we generally go by the individual’s tax return.

The SEC Report also discussed the net worth calculation. The only asset excluded from the calculation is the person’s primary residence. Many commenters have suggested changes such as the exclusion of retirement assets. The SEC rightfully points out the numerous problems with this approach including, but certainly not limited to, the obvious impact of discouraging retirement investments or encouraging the withdrawal of retirement funds to participate in private investments. Moreover, the Advisory Committee previously pointed out, and the SEC Report acknowledges, 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.

I also like the reasoning behind adding investment limitations at certain thresholds and removing them at higher thresholds. Currently the income and net worth tests are absolute. An investor with a $999,999 net worth cannot invest and an investor with a $1,000,000 can invest an unlimited amount. Permitting all individuals that with a level of financial sophistication to be deemed accredited and invest in private offering subject to caps based on net worth or income, will greatly expand the pool of potential investors and be consistent with the need to protect investors.

The SEC Reports suggests a few methods of implementing investment limitations but does not make a specific, precise proposal. The SEC Report suggests examples of limitations such as: (i) an even percentage application across all investors (this approach is rejected); (ii) a gradual increase in investment limitation which limitation is eventually eliminated based on net worth and/or income; and (iii) either separately or in conjunction with other limitations, adding a per issuer limitation.

The SEC Staff recommendations in the Report are consistent with the Advisory Committee's recommendations made to the SEC in March 2015. In particular, the Advisory Committee made four recommendations related to the definition of "accredited investor":

- 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 to income or net worth. In addition, the Advisory Committee recommended that that tax treatment of assets be excluded from any net worth calculation.
- That the SEC take into account the effect of inflation and adjust the accredited investor thresholds in accordance with the consumer price index.
- "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
- The SEC should continue to gather data on the subject.

Additional History and Further Background

The vast majority of the SEC's 118-page report provides a history of the Securities Act registration and exemption provisions and the role of the accredited investor definition. The SEC provides the background of the Section 4(a)(2) exemption and a summary of SEC vs. Ralston Purina Co., the leading Supreme Court case interpreting the provision. I've previously covered some of this history in my blogs HERE and HERE (written prior to renumbering 4(2) to 4(a)(2)). The following blog HERE on obstacles in depositing penny stocks also provides insight into the exemptions and investor qualifications and as such is beneficial ancillary reading with this blog.

The Advisory Committee Letter to the SEC in March 2015 contained a list of practical facts and realities related to small business and emerging company capital formation in support of its recommendations that I found informative and so am re-publishing. 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; and

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 concluded that if the income and net worth thresholds are increased, it “will materially decrease the pool of capital available for smaller businesses.” It continued 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.”

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

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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