GT GreenbergTraurig

ALERT

Corporate & Securities | October 2014

Investor Advisory Committee Recommends Changes to Accredited Investor Definition

On Oct. 9, 2014, the Investor Advisory Committee (the Committee) formally presented its recommendation to the Securities Exchange Commission (the SEC) regarding the definition of "accredited investor" in Regulation D. The definition, largely unchanged since its inception,[1] is aimed at identifying those who can "fend for themselves"[2] in unregistered offerings.

Whether a potential investor needs the protection otherwise afforded by registration under the Securities Act of 1933 (the Securities Act) has historically depended on three factors: (1) the investor's access to information similar to that which would be furnished in a registration statement filed under the Securities Act; (2) the investor's ability to bear the economic risk and illiquidity associated with private offerings; and (3) the investor's financial sophistication. And while the Committee agrees generally with those indicators, it believes the SEC should consider alternative approaches to the accredited investor concept that both more accurately measure the indicators and better balance investor protection goals with the need for a sufficient supply of capital in the private offering market.

The Committee's Recommendations

I. The SEC should evaluate if the current definition is effective in identifying individuals who do not need the protection of the Securities Act.

a. *Net worth and income as imperfect proxies for sophistication.*

[1] Since Regulation D's adoption in 1982, the financial thresholds for accredited investor status have remained largely unchanged. In December 2011, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC formally adopted a rule, effective Feb. 27, 2012, that amended the definition of "accredited investor" to exclude the value of an individual's home from the net worth calculation. *See* SEC Release No. 33-9287.

[2] *Securities and Exchange Commission v. Ralston-Purina Co.*, 346 U.S. 119, 125 (1953).

The Committee suggests that the use of net worth and income to determine accredited investor status misses the mark when it comes to evaluating an investor's access to information, ability to bear risk, and financial sophistication. The Committee believes that today's standards result in an overinclusive class of investors—one that includes individuals who, despite their substantial wealth, cannot adequately evaluate financial risks and alternatives. Although evidence suggests that there is some correlation between wealth and financial sophistication, the Committee presents other evidence that wealthy individuals scored only slightly better than the national average on FINRA's 2009 National Survey of Financial Capability, which measures an understanding of only the most fundamental concepts such as inflation, compound interest, and mortgages.[3] In addition, a purely monetary net worth calculation has not adequately accounted for assets such as a family farm, a retirement account, or a closely held business that significantly impact the investor's risk tolerance.

b. *Adjusting for inflation may not be the answer.*

The Committee also highlights that the net worth and income thresholds have not changed since first set over 30 years ago. Adjusting only for inflation would result in a net worth threshold of about $2.5 million and an income threshold of nearly $500,000 ($740,000 for a married couple).[4] Critics allege that adjusting for inflation will constrain the flow of capital to private offerings by making ineligible what the SEC estimates to be about 60 percent of today's accredited investors.[5] As the SEC believes that "only a small percentage of [those] households are likely to participate in securities offerings, especially exempt offerings,"[6] whether issuers would lose a significant portion of their private offering investors as a result of the inflation-adjusted thresholds remains an open question. Still, adjusting for inflation alone may not be effective due to the changing makeup of the investing public and the availability of complex financial products.

c. *The SEC should adopt earlier recommendations of the Committee regarding Regulation D information collection.*

Central to the SEC's ability to draft a definition that best approximates an investor's ability to fend for him- or herself is a better understanding of the participants in the private offering market. The SEC has admitted to having "relatively little information on the types and number of investors in Rule 506 offerings."[7] Forms D are often incomplete and provide only a small glimpse into the private offerings market. Before reforming the accredited investor definition, the Committee urges the SEC to engage in an information-gathering process to better understand the impact of potential changes by adopting the amendment to Regulation D first proposed in 2013.[8]

---

[3] Recommendation of the Investor Advisory Committee: Accredited Investor Definition, October 9, 2014, at 3, available at http://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf [hereinafter IAC Recommendation].
[4] *Id.* at 4.
[5] *Id.* at 5.
[6] *Id.* (internal quotation marks omitted).
[7] *Id.* (internal quotation marks omitted).
[8] *See* SEC Release No. 33-9416.

d. *Alternative approaches would be more effective in defining persons capable of fending for themselves.*

Alternative approaches looking at financial assets or liquid assets may be more appropriate. Consideration should be given to excluding certain assets, such as retirement accounts, and lessening risk by restricting the percentage of assets that could be invested. The SEC should also consider whether an alternative approach to relying on net worth and income measures would be more effective in determining whether potential investors are able to fend for themselves.

II. Accredited investor status based on financial sophistication.

The Committee submits that the current "accredited investor" definition's reliance on strict financial metrics also creates an underinclusive class—one that excludes certain investors who, but for their lesser income or lower net worth, would qualify based on other measurements such as their financial sophistication. Utilizing other qualifications like one's professional credentials, investment experience, and financial knowledge would provide an alternative route to participation in private offerings.

For example, the Committee cites the Series 7 license and the Chartered Financial Analyst designation as two measures for accredited investor status based on professional credentials. It becomes more difficult to draw the line, however, when considering other professions such as attorneys, accountants, and directors of companies. The concept of "knowledgeable employee" could be explored as a means to measure financial expertise. Alternatively, individuals could qualify as accredited investors based on their investment experience. In 2007, the SEC explored just such an alternative when it proposed an "investments owned" test.[9] The rule amendment was never adopted. Under these more flexible standards, a drawing-the-line problem emerges—how much experience is necessary? Must the investment experience be in stocks of unlisted companies? Does membership in a network or investment syndicate qualify? As a third possibility, the Committee introduces the concept of a uniform financial literacy test developed by regulators or third parties.

Each of the methods to achieve accredited investor status described above is undoubtedly subject to certain limitations, but in an effort to introduce new investors to the marketplace, the Committee urges the SEC to consider other permutations of the "accredited investor."

III. A sliding scale approach to participating in private offerings.

Although the current definition of "accredited investor" affords a level of simplicity both for issuers and prospective investors, the definition does little to prevent an investor, once qualified, from taking on an inappropriate amount of risk. According to the Committee, the current "on/off switch"[10] approach leaves individuals with annual incomes just a few dollars below the threshold shut out from the private offering market entirely, while allowing those just a few dollars above the threshold to roll the dice with as much money as they wish. Rather, the Committee envisions a sliding scale approach to participating in private offerings in which the amount of money a potential investor can put at risk is a function of the investor's income or other financial measure. Such an overhaul would provide the dual benefit of exposing issuers to previously untapped capital sources (depending on the initial qualification value) and protecting investors from taking on excessive risk relative to their income, net worth, or other sophistication metric.

---

[9] *See* SEC Release No. 33-8828.

[10] IAC Recommendation, *supra* note 3, at 9.

The Committee also highlights an additional benefit of this sliding scale approach—its ability to replace completely the current standards. Under this approach, investments could be made once a person reaches an initial threshold, based on percentages of income or assets, with restrictions reduced and then eliminated as income or assets rise.[11] In order to design a lockstep scheme like the one advocated by the Committee, the SEC would need to evaluate (1) an appropriate "entry level value" for potential investors; (2) acceptable ratios of certain financial metrics for exposure to the private offering market; and (3) an appropriate "exit horizon," above which the investor is no longer subject to investment restrictions.

IV. Verification of accredited investor status.

Given the complexity of the Committee's suggested revisions to the "accredited investor" concept, it is unsurprising that the issuer community has raised concerns about the cost of compliance. To take advantage of the changes now permitting general advertising and solicitation in Regulation D offerings, Rule 506(c)(ii) requires issuers to take "reasonable steps" to verify a potential investor's status as an accredited investor. Under the current regime that utilizes annual income and net worth as proxies for investor sophistication, the verification process is relatively straightforward. The introduction of additional complexity could significantly restrict access to capital by issuers not able to bear the cost associated with a more robust investigatory process and analysis. Recognizing these concerns, the Committee encourages the SEC to consider, after careful study, a third-party verification process by which qualified individuals such as attorneys, brokers, accountants, and investment advisers, or private entities could provide the verification services required for compliance with the accredited investor definition for all Regulation D offerings.

V. Greater regulation of purchaser representatives.

In its final proposal, the Committee suggests that, in addition to changes to the definition of "accredited investor," the SEC consider adopting a more robust set of regulations aimed at protecting nonaccredited investors who rely on purchaser representatives to gain access to private offerings. Under Rule 506(b), an issuer may sell securities to up to 35 nonaccredited investors as long as the offering does not involve general solicitation of potential investors and the issuer provides to such nonaccredited investors information that is generally the same as that required in a registration statement. Certain potential investors who otherwise fail to qualify as accredited investors may nonetheless participate in Regulation D offerings by using a purchaser representative. Purchaser representatives are currently subject to certain disclosure requirements,[12] but are otherwise largely unregulated. As part of its goal to curb financial conflicts of interest, the Committee calls for the SEC to prohibit purchaser representatives from "having any personal financial stake in the investment"[13] and from accepting payment from the issuer. The Committee further advocates for the imposition of a fiduciary duty on the purchaser representative to act in the best interests of the investor where the purchaser representative is compensated for his or her services.

[11] *Id.*
[12] *See* 17 C.F.R. § 230.501(f)(4).
[13] IAC Recommendation, *supra* note 3, at 11.

VI. Conclusion.

While some of the Committee's suggestions offer more promise than others, it is clear that change is coming to the private offering landscape. Issuers are urged to carefully monitor the progress of this process and analyze the potential impact of the coming changes.

This *GT Alert* was prepared by **Jean E. Harris**, **Paul Berkowitz**, and **Zachary A. Greenberg**. Questions can be directed to:

- Jean E. Harris | +1 602.445.8310 | harrisj@gtlaw.com
- Paul Berkowitz | +1 305.579.0685 | berkowitzp@gtlaw.com
- Zachary A. Greenberg | +1 602.445.8212 | greenbergz@gtlaw.com
- Or your Greenberg Traurig attorney

Albany
+1 518.689.1400

Amsterdam
+31 (0) 20 301 7300

Atlanta
+1 678.553.2100

Austin
+1 512.320.7200

Boca Raton
+1 561.955.7600

Boston
+1 617.310.6000

Chicago
+1 312.456.8400

Dallas
+1 214.665.3600

Delaware
+1 302.661.7000

Denver
+1 303.572.6500

Fort Lauderdale
+1 954.765.0500

Houston
+1 713.374.3500

Las Vegas
+1 702.792.3773

London*
+44 (0) 203 349 8700

Los Angeles
+1 310.586.7700

Mexico City+
+52 (1) 55 5029 0000

Miami
+1 305.579.0500

New Jersey
+1 973.360.7900

New York
+1 212.801.9200

Northern Virginia
+1 703.749.1300

Orange County
+1 949.732.6500

Orlando
+1 407.420.1000

Philadelphia
+1 215.988.7800

Phoenix
+1 602.445.8000

Sacramento
+1 916.442.1111

San Francisco
+1 415.655.1300

Seoul∞
+82 (0) 2 369 1000

Shanghai
+86 (21) 6391.6633

Silicon Valley
+1 650.328.8500

Tallahassee
+1 850.222.6891

Tampa
+1 813.318.5700

Tel Aviv^
+972 (0) 3 636 6000

Warsaw~
+48 22 690 6100

Washington, D.C.
+1 202.331.3100

West Palm Beach
+1 561.650.7900

White Plains
+1 914.286.2900