SEC Issues Report on Review of "Accredited Investor" Definition

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On December 18, 2015, the Securities and Exchange Commission (the "SEC") issued a report evaluating the definition of "accredited investor" as part of its obligations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This is the first report that the SEC has issued pursuant to the Dodd-Frank Act, which instructs the Commission to evaluate such definition every four years and which definition has not been meaningfully evaluated since 1982. Significantly, the report recommends modifications to the definition of "accredited investor" that could pose considerable impact on capital fundraising and the ability for issuers to rely on exemptions from registering their securities offerings.

The Dodd-Frank Act currently defines "accredited investors" as those natural persons whose income exceeds $200,000 individually or $300,000 jointly with their spouses for the two most recent years and who reasonably anticipate income to remain constant in the current year; those natural persons whose net worth exceeds $1 million, excluding the value of their primary residence; and certain entities with assets exceeding $5 million. The definition of "accredited investor" is central to issuers' ability to raise capital because it allows issuers to fundraise from a broad audience of certain sophisticated investors while still relying on the exemptions found within Regulation D, which avoids the need for the issuer to engage in an onerous offering registration process. The report notes that issuers relying on Regulation D were responsible for raising more than $1.3 trillion in capital in 2014–an amount similar to that raised in registered offerings. As such, modifications to the accredited investor definition, which defines investors who may participate in Regulation D offerings, could have a dramatic effect on capital markets, and particularly on small businesses and private investment funds who rely on Regulation D for their primary means of capital raising.

The SEC noted in the report that, in effecting its task to balance investor protection with capital formation, they evaluated the attributes of certain types of investors and the circumstances in which they invest in order to present recommendations for modifying the definition of "accredited investor." In so doing, the report advances two broad categories of revisions to the definition, the first of which suggests revising the financial thresholds for individuals and entities to qualify for accredited investor status, and the second of which suggests establishing criteria to allow certain types of investors to qualify for the definition by non-financial means.

Financial Threshold Recommendations

The report suggests that the Commission consider one or more of the following recommendations as related to the required financial thresholds for individuals or entities to qualify for "accredited investor" status:

- Impose investment limitations on the current income and net worth thresholds, such as limiting investments made in a 12-month period to 10% of an individual's net worth or 10% of his or her prior year's income;
- Increase current income and net worth thresholds to adjust for inflation, such as $500,000 minimum income for individuals ($750,000 jointly) or $2.5 million in net worth, without imposing investment limitations;
- Index all financial thresholds for inflation on a going-forward basis every four years;
- Add the term "spousal equivalent" to the definition to allow individuals in marriages, civil unions, and domestic partnerships to pool income in order to satisfy income thresholds;
- Permit any entity, not just the current enumerated list, with at least $5 million in "investments" to be an accredited investor. "Investments" to be defined in the same manner as SEC Rule 2a51-1(b) under the Investment Company Act, which is used in other

contexts to determine whether an investor will be a "qualified purchaser." Also considers replacing the current assets-based test with an "investments" test for all entities;

- Grandfather issuers whose investors are currently accredited to maintain their status in future offerings in such issuers' securities.

Non-Financial Threshold Recommendations

The report further suggests that the following non-financial attributes be considered as a way of qualifying certain sophisticated individuals whose income does not otherwise meet financial thresholds to nonetheless invest in private offerings:

- **Minimum Investment Amounts**: While no specifics are recommended, the report suggests considering a minimum amount of investments made by an individual as a way to evaluate such person's ability to evaluate and weather financial risk;
- **Professional Credentials**: Individuals who possess certain professional credentials, such as having passed the Series 7, Series 65, or Series 82 examination, are recommended as sufficiently sophisticated to qualify for the definition;
- **Past Investment Experience**: The report suggests considering past investment experience in determining investor sophistication, such as the investment in at least ten private offerings by different issuers;
- **Knowledgeable Employees of Private Funds**: The report recommends including knowledgeable employees of private funds as accredited investors due to their experience with investment decisions on a consistent basis;
- **Accredited Investor Exam**: Lastly, the report suggests creating an examination to objectively evaluate an investor's ability to appreciate the risks associated with investments, with those passing qualifying for "accredited investor" status.

The SEC is currently seeking public comment in response to the recommendations contained in the report. Foley Hoag will monitor any developments in this area and advise our clients accordingly.

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