Securities
Regulation Daily

March 5, 2020

A Discussion Concerning the SEC's Proposed Changes to the Accredited Investor Definitions

By *Allan Grauberd* and *Howard Fischer*, Moses & Singer LLP*

Introduction

This discussion of the SEC's proposed changes to the accredited investor definitions is in two parts. The first focuses largely on the proposed expansion to the definition of "accredited investor," i.e., who is allowed to invest in unregistered offerings, as well as some of the history behind that change. The second part focuses on issues related to capital formation and access to economic activities that the defenders of the proposed rules emphasize, among other aspects.

I. Who Are Accredited Investors?

Allan: Over the last year, the SEC has been aggressively pursuing an agenda of regulatory reform. In addition to a significant restructuring of the rules for shareholder proxies, and a modification of auditor independence standards, the SEC has proposed rule-making related to the question of who qualifies as an accredited investor. It first issued a "concept release" on June 18, 2019, that solicited public comment on methods for "harmonizing" the exempt offering framework under the Securities Act[1] It followed that with the proposed amendments, which were published on December 18, 2019. The public comment period has just ended[2].

Allan: Howard, as a former SEC insider, what can you tell us about the internal considerations motivating the proposal? Are there any divisions within the SEC about this? Give us the inside scoop.

Howard: The proposed rules are controversial within the SEC, and the split breaks along partisan lines. Other than the Chair, each of the four other Commissioners issued public statements accompanying the announcement of the proposed rules. These statements illustrate not only the political divide at the Commission, but also outline distinct views as to the proper scope of regulation, the appropriate limits of investor protection, and the centrality of promoting capital formation to the SEC's mission.

---

* **Allan Grauberd,** an experienced transactional securities counsel, is a partner and Chair of Moses & Singer's capital markets practice. **Howard Fischer,** a former SEC enforcement and senior trial counsel, is a securities litigator partner at Moses & Singer.

1 See our client alert, *The SEC Goes Big With A Concept Release Suggesting An Ambitious Re-Examination Of Private Capital Formation Exemptions*

2 As of February 20, 2020, well over a hundred comments had already been filed.

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

Commissioner Lee, a Democrat appointee, views the proposed rules as "expanding the pool of investors in the opaque and indisputably high-risk, private markets." She sees using wealth as a proxy for sophistication as problematic, noting that many retirees, after a lifetime of savings, satisfy the wealth thresholds, but lack the relevant experience managing investments, leaving them susceptible to fraud. She also criticizes the failure to index the thresholds to account for inflation over the last four decades.

Commissioner Jackson, the other Democrat on the Commission, argued that the revisions were not based on data but driven instead by ideology. He stressed that private placements correlated to a high rate of misconduct and customer complaints, and expressed concern that the proposals exposed ordinary investors to unacceptable levels of risk.

The Republican Commissioners, on the other hand, see the proposed changes not as exposing unsophisticated investors to greater risk, but as providing them a ccess to greater opportunities. Commissioner Peirce sees accredited investor limitations as essentially an infringement on liberty and "as one of the more offensive concepts lurking in our federal securities laws" with a "corrosive effect on an individual's economic liberty." For her, the current rules are not only a restriction on liberty, but are biased against individuals from the American heartland where lower incomes relative to locales like "New York or San Francisco" further limit their freedom.

Commissioner Roisman operates from the assumption that the accredited investor restrictions preclude "millions of Americans [from] opportunities for them to invest their wealth in private offerings." He assumes not only that private offerings are "investments that have the most upside for growth over time" but also that newly accredited investors will provide much needed capital to smaller companies.

These differing viewpoints reflect a fundamental disagreement as to whether the revisions are exposing investors to greater opportunities, or to greater risks, and reflect a substantial dispute as to the worth of investing in unregistered opportunities.

Allan, can you walk us through the current status of the law? As well as proposed changes?

Allan: What does it mean to be accredited? Currently, for individuals, it is based on income or net worth. The current definition of an accredited investor is set out in Regulation D. Rule 501 defines an individual accredited investor as one with a net worth exceeding $1 million (excluding the value of a primary residence), or an income of $200,000 over the last two years, or joint income of over $300,000 with their spouse over the same period, and an expectation of the same income level in the current year.

An accredited investor is able to invest in private offerings. Regulation D is a safe harbor exemption for private offerings that are not required to be registered under the Securities Act of 1933. While unaccredited investors can invest in certain private offerings under Regulation D (under Rule 504

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

for example)[3], there are investment round limits and state blue sky restrictions that make these offerings less practical. As a general matter, most private offerings are conducted under Rule 506(b), which allows an unlimited dollar raise and does not require any specific information be provided to accredited investors (even though up to 35 unaccredited investors can participate if they are "sophisticated"). The problem with even a limited number of unaccredited investors participating in a 506(b) offering is that they must be provided "prospectus style" disclosure. To avoid this burden, most offerings simply prohibit participation of unaccredited investors.

Howard: So how do the proposals move away from current rules? And how drastically do they change the current standards?

Allan: It appeared that the SEC's original goal was to more drastically expand the universe of those considered accredited. The actual expansion is a little less ambitious than originally anticipated.

The main premise of the proposal is that wealth should not be the sole proxy for financial sophistication (21)[4]. Instead, the Commission would accept as qualifying various professional qualifications and licenses.

- The Commission intends to have a flexible view of the type of educational qualifications that would allow the Commission, by order, to certify accredited status. (28)
- Initially, the expected certification will be limited to various securities licenses, including the Series 7, Series 65, and Series 82. Of those, only the Series 65 exam allows a person to take the test without being affiliated with a FINRA member firm. (29-30).
- The SEC proposed to add a new category of accredited investors: registered investment advisers. (47).

Howard: Allan, we discussed this first when the initial concept release came out, and one of the things that struck us both was the difference between the scope of the original plans and what was ultimately announced. What was the most surprising omission from the original concept release? What is it surprising not to see?

Allan: All in all, the emphasis on securities professionals as being the only certifications the Commission is publicly advocating for is disappointing. The democratization of the accredited investor world should have a way in without requiring all the public securities knowledge inherent in the Series 7, 65 and 82 exams. It is also unclear that having various securities licenses provides the kind of training most appropriate for investing in restricted offerings. For example, knowing how to critically read a private placement memorandum and how to analyze a Reg. D offering are different skills than knowing how to assess the securities or debt of a listed company or of government bonds. While some aspects of the listed exams focus on private offerings, it is a far broader exam than needed.

3 See our article *The Revised Regulation D Rule 504 Exemption-Bigger And Better December 15, 2016*

4 Numbers in parentheses refer to the numbered pages of the SEC's December 18, 2019, which can be found at https://www.sec.gov/rules/proposed/2019/33-10734.pdf

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

It would seem self-evident, as Commissioner Lee pointed out, that having a certain level of income or net worth does not imply a level of investment sophistication. The idea that finding different channels into the accredited investor world is a worthwhile goal would suggest a recognition that there are a variety of ways to educate oneself on the needed skills to be an investor in private placements. Indeed, as a practitioner, there are a specific variety of skills that are necessary to make investment decisions, mostly dealing with the ability to evaluate a business plan, financial statements, corporate structural issues, as well as experience with valuation and tax issues. The SEC seems open in the release to broadening the types of professional credentials and testing that might allow others to qualify, but at this point does not venture beyond the familiar professionals it regulates (28,39).

In addition to questioning whether certain advanced degrees like law and accounting should be a qualifying skill, or experience in finance and investing (38-39), the Commission also asks if they should support the development of an accredited investor examination (39). A tailored course would seem much more suited to the needed skills then other types of degrees and certifications. See for example VC University's online course and certification (Sponsored by the National Venture Capital Association and Berkeley Law of the University of California).

The Commission notes that those having general advanced degrees are not viewed as appropriate for certification in the absence of a focus on securities and investing (32).

The Commission also questions whether the extension of accredited investor status to those individuals not meeting net worth and income standards suggests a need for limits on investment size (similar to the crowdfunding exemption). (38)

Howard: One can question how much of an expansion this actually is. After all, it is entirely likely that most of the people who have securities licenses also qualify on the basis of income and assets, so you are not significantly expanding the number of accredited investors.

On the other hand, wealth as the determinant of investor readiness makes little sense. When I was at the SEC, I prosecuted a number of cases involving unregistered offerings where the investors were "qualified" in the economic sense – doctors, psychiatrists, professionals of various stripes – but that did not stop them from being victimized. These investors did not understand how to read a prospectus, how to analyze how fees were charged, or how to critically look at investment strategies. Frequently, they were induced to invest such substantial sums (including borrowing money) that the failure of the fraudulent schemes left them relatively destitute. The idea that accredited investors would only invest risk capital that they could afford to lose was not borne out in the cases I handled.

Allan: This points to understanding risk allocation skills, which are of course not connected to the current financial standards in the accredited investor qualifications. Requiring educational qualifications that are more suitable to private offerings seems the way to proceed, including understanding their higher risk profile. I hope that future SEC certifications head in that direction.

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

II. Structural Changes

Allan: Notably, the proposals reflect a view of unregistered investments that might seem at odds with the traditional SEC view of these as "dangerous opportunities." The proposals seem to reflect the idea that accreditation rules are obstacles to financial growth opportunities, not dangerous risks.

Howard: The arguments utilized by proponents of increased access, that (1) liberalizing access lets more people enjoy the above-average returns generated by such funds; and (2) that increasing the pool of capital available to investment funds is good for the economy, do not seem to have much empirical support that I have seen. At the very least, the evidence is equivocal at best.

Allan: Howard, you mentioned to me the other day that the SEC proposal justifies a loosening of the accreditation standards by arguing that the proposal will allocate capital to businesses that lack for it, including minority-owned businesses. Can you comment on that?

Howard: The proposal notes that "small businesses typically do not have access to registered capital markets and commonly rely on personal savings, business profits, home equity loans, and friends and families as initial sources of capital. Small issuers that face more challenges in raising external financing may benefit more from increased access to accredited investors." (129).

I am slightly skeptical that small businesses are ready to go out into the capital markets or, if they are, whether or not these are appropriate investments for newly accredited investors. There doesn't seem to be much empirical data to support either claim.

Another supposed need being filled is that of minority owned businesses having access to capital. The proposal notes that "businesses owned by underrepresented minorities may benefit from increased access to accredited investors. . .businesses owned by underrepresented minorities were more likely to demonstrate unmet credit needs relative to other groups, which suggests that these businesses may benefit from amendments intended to facilitate private market capital raising." (129-130). Note the careful language used – the information "suggests" that these businesses "may benefit." These phrases indicate the lack of empirical data one way or another.

As Commissioner Lee noted in her comments, one issue that bedevils minority-owned enterprises is the recurrent discrimination faced in seeking credit; it is unclear how loosening accreditation standards would ameliorate that discrimination, or how it would prevent its recurrence in the investment sphere. Moreover, it is not clear why more access to debt financing would not resolve this issue.

Allan: Another interesting point regarding a structural matter is the argument that the increased access to information in the internet era has helped level the field between professional and amateur investors. "Given the rise of the internet, social media, and other forms of communication, information about issuers and other participants in the exempt markets is more readily available to a wide range of market participants." (79). Commissioner Lee cautions, however, that this "fails to consider a growing body of research showing the massive amount of misinformation on the internet, and the

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

inability of many to discern fact from fiction in this environment." As anyone who spends time on social media can attest, that might not be an arena best suited for the dissemination of relevant and accurate information.

Howard, does your prior experience as a securities enforcer give you any additional insights into this?

Howard: The issue I have seen has not related to the amount of information availability, but to its quality, and to the difficulties inherent in distinguishing between valid sources of information and less legitimate sites. There are a multitude of sites catering to smaller investors, most of which are unmoderated. In prior cases of mine, those websites often played a role in in spreading misinformation, not in countering it.

Additionally, on many of these sites the identity of the people posting was unclear. Investors who relied on these sites for information often had little idea if the sources offering the information were interested parties or not.

One of the last cases I worked on involved a scammer (who ultimately went to prison) who promoted investment opportunities through social media postings and websites purporting to contain independent analysis. Relying on the Internet as a conduit for reliable information does not seem warranted based on the current state of that medium.

Howard: Allan, what other interesting provisions are there in the proposals?

Allan: LLCs now are to be included in the same category as corporations and managers are viewed (without any amendment) to be in the same category as executive officers (most practitioners already considered LLCs accredited under staff interpretations[5] or as an entity whose equity owners are accredited under 501(a)(8)) (51-54).

The addition of Rule 501(a)(9) will now qualify as accredited any entity not formed for the specific purpose of acquiring the securities at issue and having more than $5 million in investments (rather than simply that value in assets). This would include Indian tribes, labor unions, as well as government bodies and funds. (55-60)

Note the SEC did not make any changes in the status of trusts. It has been hoped by many practitioners that trusts would qualify under 501(a)(8) as an entity in which all investors (substituting here beneficiaries) are accredited (which up to now has been a no-go) Alas, it remains a no-go regardless of the sophistication of the trustee. However, trusts appear to be included under Rule 501(a)(9) regardless of the sophistication of the trustee, essentially making Rule 501(a)(7) obsolete except to those trusts only owning assets and not $5 million in investments).

5 See Division of Corporation Finance interpretive letter to Wolf, Block, Schorr and Solis-Cohen (Dec. 11, 1996); and question number 255.05 of Securities Act Rules Compliance and Disclosure Interpretations, available here.

 ©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.

The Commission also proposes to include in the definition of "accredited investors" family offices (entities highly affluent families set up to manage wealth for family members) with more than $5 million in assets under management, as well as their family clients. (60-63) The family office would need to be directed by an experienced and knowledgeable person. (63). Also, "knowledgeable employees" of private funds are proposed for inclusion (39).

Other concepts floated in the Concept Release and not included in the proposed rules include an "opt-in" to accredited investor status after receiving certain risk factor disclosure, and permitting an investor advised by a financial professional to qualify (although the latter was raised as a possible area for consideration). As noted earlier, while the SEC generally supports examinations as a way of qualifying for accredited status, it has limited the first certifications to securities licensing exams.

©2020 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from Securities Regulation Daily.