Statement on the Proposed Expansion of the Accredited Investor Definition

Commissioner Allison Herren Lee

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Today's proposal would expand the definition of accredited investor in numerous ways. These proposed changes all go in one policy direction—toward expanding the pool of investors in the opaque, and indisputably high-risk, private markets. And once again, we propose to do so without adequately analyzing significant and relevant data, as Commissioner Jackson has carefully demonstrated.

The proposal contains a number of features that I hope will engender robust comment and analysis.[1] I will focus my remarks today, however, on the primary reason I cannot support sending this proposal out for comment—the approach it takes to the income and net worth thresholds. There is serious risk to retail investors, particularly elderly investors who have spent a lifetime saving for retirement, in the path this proposal takes.[2] And much of the rationale provided for this policy choice is problematic.

While I do not agree with significant policy choices reflected in this proposal, I want to recognize the work of the staff in the Division of Corporation Finance, the Office of the General Counsel, and the Division of Economic and Risk Analysis, which as usual reflects their expertise and dedication.[3] I sincerely appreciate their efforts.

Many argue, and not without merit, that wealth thresholds offer a clumsy proxy for sophistication. They point out that these thresholds may be under-inclusive. Indeed, some investors who don't meet the financial thresholds nonetheless may have the sophistication to understand the risks involved in private offerings. This release proposes to address the under-inclusiveness by adding a process for the Commission to designate by order those with certain professional or educational certifications as accredited investors. As an aside, I want to note my concern that this process permits the Commission to do by order, with no obligation for future notice and comment or economic analysis, what might require rulemaking.

But my larger point is that the release wholly ignores the flip side of the problem with the wealth thresholds—they are indisputably over-inclusive, capturing investors with little to no ability to assess or bear the risks of private offerings. Consider, for example, a person who contributes a modest $200 per month to retirement over a 50-year period with an average return of seven percent. That person will have spent a lifetime accruing $1 million in retirement assets. In fact we know that an increasing amount of wealth is concentrated in older households.[4] But many such investors have spent a lifetime saving, not a lifetime actively managing investments in a way that would prepare them to fend for themselves in the private market. And once they cross the threshold, there are no limits on the amount that can be gambled and lost.[5]

This proposal makes no attempt to address the over-inclusive nature of these thresholds. Rather it would codify the toll that 37 years of inflation has already taken. Even worse, it would fail to index for inflation going forward to account for the continued erosion we know will follow. In fact, the failure to index will create some eye-popping results in terms of the percentage of U.S. households that would qualify as accredited in the future. Let's look at some numbers using an estimated annual and constant growth rate for inflation of 1.51%: In ten years, approximately 22.7%; in 20 years, 39.32%, and in 30 years, 57.3% of U.S. households will have to "fend for themselves.[6]

The failure to index for inflation going-forward is especially notable given the broad support for this idea across a wide array of groups with diverse interests. The SEC staff recommended indexing for inflation.[7] The SEC Investor Advisory Committee recommended indexing for inflation.[8] There is support for indexing from investors and their advocates, industry groups, state regulators, crowdfunders, and a diverse group of academics.[9] And finally, the SEC Advisory Committee on Small and Emerging Companies recommended indexing for inflation.[10] Nevertheless, the proposal fails to include this common-sense approach with widespread support.

If we are going to use a wealth threshold as proposed, we are obligated to calibrate that threshold, now and in the future, in a manner that does not arbitrarily freeze in place a 37-year-old rule,[11] and in a manner that is consistent with the Supreme Court's mandate in *SEC v. Ralston Purina*,[12] which is the lens through which we must view our statutory authority to define the term accredited investor.[13] This proposal fails to fulfill that obligation.

A big part of the problem here is the absence of certain data.[14] In 2013, the Commission put out a rule proposal aimed in part at enhancing our visibility into the Regulation D market.[15] This was particularly important given that we had just enacted a rule permitting general solicitation under Rule 506.[16] We never completed that rulemaking, and our lack of visibility into that market persists. Indeed, this release is replete with examples of the information we do not have.[17]

In the face of this self-imposed data deficiency, the release rests on certain premises that I hope will be carefully analyzed in the comment process. For example, in explaining the failure to increase the financial thresholds to account for 37 years of inflation, despite a 550% increase in the number of qualifying households,[18] there is a rather remarkable statement that "it *may be argued* that an investor with an income of $200,000 or a net worth of $1 million in 2019 is not as 'wealthy' as such an investor would have been in 1982."[19] How is that possibly an arguable point? That is a simple fact that should be plainly and clearly acknowledged.[20]

On that score, the release takes comfort in the fact that "the income and net worth levels currently required in the definition still exceed, by a large margin, the mean and median household income and household net worth in all regions of the country."[21] Are we suggesting here that, unless or until the financial thresholds erode to such a degree that they drop below the mean and median, they are providing adequate investor protection? There is no basis in the release, or in common sense, for such a proposition.

The release also asserts that the rise of information on the internet and social media mitigates concerns about access to information.[22] This is certainly worth considering; however, there is no discussion or examination of the amount or type of information commonly available with respect to privately-held issuers. And the release wholly fails to consider a growing body of research showing the massive amount of misinformation on the internet, and the inability of many to discern fact from fiction in this environment.[23]

Finally, the release justifies the failure to index for inflation by stating that it would be more appropriate to consider inflation during the four-year review of the accredited investor definition mandated by Dodd-Frank.[24] However, in the first of these mandated reviews in 2015, the staff made three separate recommendations to improve investor protections in the financial thresholds, including indexing for inflation.[25] Four years later, we have done nothing to implement those recommendations. This

mandated review holds little promise for actual Commission action and is no justification for declining to take this well-supported and obvious step to update the thresholds.

All of this is purportedly in order to provide more investors, including retail and elderly investors, with supposedly lucrative opportunities in the private markets—opportunities we know for certain come with much higher risk and must less transparency about the nature of that risk.[26]

It appears that the failure to update these thresholds may be less about providing American investors access to lucrative private markets, and more about providing private markets access to potentially vulnerable American investors. I cannot support the proposal, and I hope commenters will offer data and insight that help us craft a better final rule.

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[1] For instance, the proposal would permit the Commission to designate individuals holding certain professional or educational certifications or credentials as accredited investors by order without a rulemaking process that would require notice, comment, and economic analysis. *See* Amending the Accredited Investor Definition, Proposed Rule, Rel. No. [] (Dec. 18, 2019) ("Proposing Release"), at 21. I hope commenters will weigh in on whether this mechanism for designating natural persons as accredited investors permits too much flexibility to the Commission, both as a matter of policy and law, especially in light of the exceedingly broad criteria that would govern this process. The proposal would also designate knowledgeable employees of private funds to qualify as accredited investors for investments in that fund. *See id*. at 39. I hope commenters will weigh in on whether such employees who do not qualify as accredited investors based either on the existing wealth thresholds or on the proposed professional certifications are appropriate investors in private funds. For example, are such employees likely to be those whose employment activities ensure that they have meaningful investing experience and sufficient access to the information necessary to make informed investment decisions about the fund's offerings?

[2] We know an increasing amount of wealth is concentrated in older households. *See* Stephen Deane, Elder Financial Exploitation: Why it is a concern, what regulators are doing about it, and looking ahead, SEC Office of the Investor Advocate (June 2018), at 5 (citing research showing that Americans over the age of 50 account for 77 percent of financial assets in the United States). At the same time, research shows that older investors may often meet the accredited investor definition without having the financial sophistication that we typically impute to accredited investors. *See* Letter from Michael S. Finke, Ph.D. (Sept. 22, 2019) (citing and attaching research showing that "older households are at risk of meeting the accredited investor definition without having the sophistication needed to avoid high agency costs in a largely unregulated securities market"). Unless otherwise noted, letters cited are available in the comment file for the Concept Release on Harmonization of Securities Offering Exemptions, File No. S7-08-19.

[3] In particular, I would like to thank Bill Hinman, Betsy Murphy, Jennifer Zepralka, Charles Kwon, Charlie Guidry and Michael Seaman in the Division of Corporation Finance; S.P. Kothari, Hari Phatak, Vlad Ivanov, Matt Wynter and Andrew Glickman in the Division of Economic and Risk Analysis; Bob Stebbins, Bryant Morris, and Connor Raso in the Office of the General Counsel; and Dalia Blass, Sarah ten Siethoff, Melissa Gainor, Jenny Songer, Larry Pace, Benjamin Tecmire, Melissa Harke, Mark Uyeda and Matt Cook in the Division of Investment Management.

[4] *See* Deane, supra note 2.

[5] Both Congress and the Commission have increasingly recognized this risk. Congress in adopting the crowfunding exemption and the Commission in amending Regulation A included investment limits in response to the risks associated with the offerings. *See* 77 U.S.C. 77d(a)(6)(B); Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Final Rules, Rel. No. 33-9741 (Mar. 25, 2015).

[6] These figures are based on an analysis of household data from the Federal Reserve Board's SCF for 2013 and 2016, available at https://www.federalreserve.gov/econresdata/scf/scfindex.htm, using an estimated annual and constant growth rate for inflation of 1.51% and other demographic assumptions.

[7] *See* Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015) (recommending indexing for inflation "consistent with the Commission's approach in its 2007 proposed revisions to the definition, as well as the approach Congress took in the Dodd-Frank Act with respect to the 'qualified client' definition and in the JOBS Act with respect to crowdfunding and emerging growth companies.").

[8] *See* Recommendation of the Investor as Purchaser Subcommittee and the Investor Education Subcommittee of the Investor Advisory Committee: Accredited Investor Definition (Oct. 9, 2014).

[9] *See* Letters from Managed Funds Association and Alternative Investment Management Association, Alternative & Direct Investment Securities Association (Sept. 24, 2019); Investment Company Institute (Sept. 24, 2019); North American Securities Administrators Association (Oct. 11, 2019); Massachusetts Secretary of State (Sept. 24, 2019); Wefunder (Sept. 13, 2019); CrowdCheck (Oct. 30, 2019); and Elisabeth D. de Fontenay, et al. (Sept. 24, 2019).

[10] *See* Recommendations Regarding the Accredited Investor Definition from the Advisory Committee on Small and Emerging Companies (July 20, 2016); *see also* Small Business Capital Formation Advisory Committee Recommendation on Accredited Investor (Nov. 12, 2019).

[11] For context, 1982 saw the release of the Commodore 64, an 8 bit computer; a gallon of gas cost right around a dollar; and the Dow closed out at 1046.

[12] 346 U.S. 119, 125 (1953) (The Court provided that the availability of the Section 4(a)(2) exemption "should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[13] The definition of accredited investor in Securities Act Section 2(a)(15) enumerates certain categories of persons and authorizes the Commission to prescribe additional categories. 15 U.S.C. 77b(a)(15).

[14] Not only should we collect and analyze data on the private markets more closely before considering any expansion of the exempt offering framework, but we should be considering instead how to shore up our public markets. *See* Letter from Elisabeth de Fontenay, et al. (Sept. 24, 2019) ("Congress and the Commission may need to take more aggressive action to usher firms into the public markets. Such measures might include tightening the asset size or shareholder threshold in Section 12(g) of the Securities Exchange Act of 1934, or making existing securities registration exemptions available to an issuer only for a fixed time period.").

[15] *See* Amendments to Regulation D, Form D, and Rule 156, Release No. 33-9416, at 1 (July 10, 2013) ("These proposed amendments are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506.").

[16] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013).

[17] *See, e.g.*, Proposing Release at 78 ("[W]e lack comprehensive data that will allow us to estimate the unique number of accredited investors across all categories of entities under Rule 501(a)"); at 108 ("[F]rom the information reported on Form D, we do not have the ability to distinguish accredited investors that are natural persons from accredited investors that are institutions."); at 112 ("[W]e lack data to generate precise estimates of the overall number of other institutional accredited investors because disclosure of accredited investor status across all institutional investors is not required.").

[18] *See id.* at 79, Table 4.

[19] *See id*. at 78 (emphasis added).

[20] As another example, the release posits that increased access to capital may benefit minority-owned small businesses. *See* Proposing Release at 129-30. But it fails to address how increased access to capital for everyone will address systemic issues that have traditionally created barriers to capital for minority-owned businesses. *See* Robert W. Fairlie, Ph. D. and Alicia M. Robb, Ph.D., "Disparities in Capital Access between Minority and Non-Minority-Owned Businesses: The Troubling Reality of Capital Limitations Faced by MBEs," U.S. Dept. of Commerce, Minority Business Development Agency (Jan. 2010) ("A review of national and regional studies over several decades indicates that limited financial, human, and social capital as well as racial discrimination are primarily responsible for the disparities in minority business performance…. Minority-owned businesses are found to pay higher interest rates on loans. They are also more likely to be denied credit, and are less likely to apply for loans because they fear their applications will be denied.").

[21] *See* Proposing Release at 78-79.

[22] *See id*. at 79 ("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.").

[23] *See* Janna Anderson & Lee Rainie, Internet and Technology, "The Future of Truth and Misinformation Online," Pew Research Center (Oct. 19, 2017) (noting widespread belief that "fake news" stories cause confusion and finding that 51% of technologists, scholars, practitioners, strategic thinkers and others believe the information landscape will not improve in the next ten years); *see also* Katherine Clayton, et al., "Real Solutions for Fake News? Measuring the Effectiveness of General Warnings and Fact-Check Tags in Reducing Belief in False Stories on Social Media," Political Behavior 1: 1–23 (Feb. 11, 2019) ("The public's vulnerability to false information has grown as people have come to increasingly rely on social media as a source of news."); David M. J. Lazer, et al., "The Science of Fake News," 359 SCI. 1094 (Mar. 2018) ("The rise of fake news highlights the erosion of long-standing institutional bulwarks against misinformation in the internet age.").

[24] *See* Proposing Release at 82.

[25] *See* Staff Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015) (recommending indexing for inflation and two other financial threshold-related investor protections).

[26] *See* Letter from Elisabeth D. de Fontenay, et al. (Sept. 24, 2019) ("[I]nvesting in private securities would pose considerable additional risks for retail investors, relative to investing in public securities, and existing research suggests that these additional risks would not be sufficiently offset by higher expected returns.").