Securities Regulation Daily Wrap Up, TOP STORY—Small biz advisory committee ponders accredited investor definition, (Feb. 10, 2022)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

Current income-and worth-based investment thresholds shut out many highly sophisticated investors, particularly minorities, women, and those not on the coasts.

The SEC Small Business Capital Formation Advisory Committee met to discuss how the definition of "accredited investor" affects capital raising opportunities for entrepreneurs and investors. The committee heard from Shelly Omilâdè Bell (Black Girl Ventures) and Eli Velasquez (Investors of Color; Angel Capital Association) about how they themselves were unable to invest in private offerings despite their financial sophistication and an intimate understanding of the businesses they would be interested in funding. Ultimately, no one on the committee supported raising the accredited investor thresholds, and the committee will recommend that the SEC explore other avenues for investors to gain accredited status beyond income and net worth.

Background. Martha Miller, Advocate for Small Business Capital Formation, laid out some background for the meeting. The SEC's current rulemaking agenda includes seeking public comment on updates to the financial thresholds in the accredited investor definition as a part of potential changes to the exempt offering rules. In 2019, the advisory committee had evaluated potential amendments to the accredited investor definition and offered recommendations to the Commission. The SEC then updated the rules to allow individuals to invest in the private markets based on certain measures of financial sophistication, not just wealth or income.

Inclusion and closing gaps. At the advisory committee meeting, however, a consensus formed around the idea that more work needs to be done to ensure that informed, sophisticated investors can back startups and emerging companies raising funds through exempt offerings. Bell and Velasquez spoke about how despite their outreach and work with entrepreneurs, they are unable to invest because they do not (or did not until recently) meet the accredited investor definition. Meanwhile, Velasquez said he a much younger and less experienced colleague write checks because he was able to access a trust fund. Any definition of accredited investor should take into account geography and income inequality, he said, and be mindful that wealth is often transferred generationally. Bell added that this is about economics, not charity, and the SEC is supposed to serve all investors. Broad participation is vital to economic development and the health of the country, she said.

Bell explained how the network effect and the accredited investor definition combine to shut out investors. Because entrepreneurs can broadly solicit only if the investment is limited to accredited investors, for someone outside of the entrepreneurs' network, the only way to learn about an opportunity is if there is a broad solicitation, but then the person can't invest. Velasquez agreed and described how his organization has to be extremely proactive—they call it "hand-to-hand combat"—in creating communities of investors with interests in particular industries.

Fraud vs. risk. Bell also observed that the conversation should start by identifying the problem to be solved. If that problem is fraud, there may be other solutions rooted in technology or reporting. Committee member Sara Hanks (CrowdCheck, Inc.) stressed that there a need to decouple risk from fraud. Pushing back on Commissioner Crenshaw's opening remarks about loss mitigation, Hanks said that this is not the SEC's purpose: the securities rules are about understanding, but not preventing, the risk of loss.

Committee co-chair Jeffrey Solomon (Cowen, Inc.) observed that more inclusion means more people will lose money. While portfolios mean that hopefully gains outweigh losses over time, if an investor's first three investments lose, the investor has a problem. Jason Seats (Techstars) said that the restrictions on private investments are pushing people towards risky behaviors instead of well-vetted private companies where a lot of value is being created. In addition to solving for fraud, the question should be how to keep investors from taking on too much risk at the beginning of the learning curve. Sapna Mehta (Rise of the Rest Seed Fund; Revolution) added that where people are allowed to invest in meme stocks, it seems patronizing to tell investors, especially those who are working alongside startups, that they can't invest.

Youngro Lee (NextSeed) went so far as to say that alongside a reevaluation of the accredited investor definition, there needs to be a rework of the definition of a security, because there is no investor protection for non-securities like NFTs, real estate, collectibles, and crypto. Here, Bell cautioned against adding in so many issues that there is no forward progress at all. While she thinks it's inevitable that there will be a reevaluation of what constitutes a security, she said that progress tends to get stuck when policy reform is a condition.

Revisited recommendation. After adjourning for lunch, the committee focused on articulating a set of recommendations to take back to the Commission. Chair Carla Garrett (Potomac Law Group PLLC) polled members, which revealed that not a single member present believed that the financial thresholds for accredited investor status should be adjusted upward or be made retroactive to 1982, when the rule was first enacted. Sue Washer (Applied Genetic Technologies Corporation) floated the idea of a maximum investment independent of the investor's income or wealth.

The committee brainstormed other possible avenues for investors to qualify beyond simple dollar thresholds. In summary, Garrett ran down the new recommendations. She emphasized that the submission to the SEC should include as background and context that the committee, having been charged with helping small businesses with capital formation, is mindful of not limiting small investors, increasing the wealth gap, becoming less inclusive, or otherwise creating unintended consequences particularly, as Hanks added, with respect to the Section 12(g) registration thresholds.

With no nay votes, the committee passed the following recommendations:

- First, the committee will reiterate the first two recommendations from 2019 dealing with the financial thresholds, including possible indexing to inflation.
- Second, the committee will revisit the third 2019 recommendation by recommending a broadened definition of a sophisticated investor and listing factors that SEC staff could look at such as investment experience; membership in an angel group; other degrees and professional accreditations; and an understanding of the particular investment the individual is interested in funding.
- Finally, the committee will issue a new fourth recommendation that the SEC allow micro and local investments.

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