

Investor Advisory Committee Advises SEC to Revisit Definition of “Accredited Investor” and Provide Enhanced Protections

The amount of funds raised through private placements has become increasingly significant in the United States. When companies are not conducting a public offering and raise capital through a private placement instead, they often seek to demonstrate compliance with Rule 506 of Regulation D to ensure that they do not trigger the registration and disclosure requirements set forth in the Securities Act of 1933.

Rule 506 of Regulation D currently allows for sales to an unlimited number of “accredited investors” for an unlimited dollar amount. The lack of restrictions on the number of accredited investors that can participate in a Rule 506 offering, as well as the lack of a ceiling on the amount of funds that may be raised under this rule, have made Rule 506 popular amongst companies in need of capital and individuals wanting to invest.

The concept of “accredited investor,” therefore, has received much attention from scholars, regulators and practitioners because it serves as the gateway for screening individuals who are eligible to participate in a Rule 506 offering. On October 9, 2014, the Investor Advisory Committee (the “Committee”), established pursuant to Section 911 of the Dodd-Frank Act to advise the Securities and Exchange Commission (“SEC”) on regulations, also turned its attention to the current definition of “accredited investor” as it pertains to individuals. In doing so, the Committee noted that “[q]uestions have been raised . . . over whether the current definition effectively defines a class of individuals who are able to ‘fend for themselves’ without the protections afforded by the ‘33 Act.”

Under the current SEC rules, for a natural person to qualify as an “accredited investor,” he or she must meet the requirements of either the income test or the net worth test. Under the income test, the individual must have income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000. Under the net worth test, an individual must have a net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase of securities, excluding the value of the primary residence of such person. The Committee [criticized this definition on several grounds and proposed changes to it.](#)

The Committee emphasized that, even though the foregoing definition may be easy to implement because it provides for clear-cut thresholds, “this approach over-simplifies the factors that determine whether an individual truly has the wealth and liquidity to shoulder the potential risks of private offerings,” which is one of the reasons why participation in private offerings is limited, in large part, to accredited investors. For example, while the net worth test excludes a person’s primary residence among the assets to be counted, it does not exclude a person’s retirement account, a family farm or other illiquid investments. Consequently, the Committee reasoned that, if persons are accredited investors based largely on ownership of these latter assets, they “could be forced to sell that farm or business if they are heavily invested in an illiquid private offering and find themselves in need of cash.” Thus, the current definition may include some persons that do not have the actual financial ability to sustain a total loss in a private investment. As such, the Committee suggested that the SEC may consider basing the “accredited investor” definition on financial assets or liquid assets, or even excluding certain assets from the calculation (such as a retirement account).

The Committee also noted that the current definition operates as an “on/off” switch because “an individual with a net worth of \$999,000 can’t invest a dime in Rule 506 offerings, but an individual with a net worth of \$1 million can risk it all.” In response to this problem, rather than simply adjusting the thresholds (which were set in 1982) to account for inflation, the Committee suggested that a better approach may be to “allow

some investments in private securities once a person reaches an initial threshold, based on percentage of income or assets, with restrictions being reduced and then eliminated as income or assets rise.”

Another reason why participation in Rule 506 offerings is limited, in large part, to accredited investors is because such individuals are presumed to be able to negotiate access to relevant information with the issuers and be “sufficiently financially sophisticated, based on their knowledge and experience and in particular their ability to evaluate risks and merits, to make an informed investment decision without the full disclosure provided in a public offering.” The Committee noted that the current definition is “a highly imperfect proxy for financial sophistication and access to information” because there may be individuals who possess these attributes but fail the current test because they fall below the thresholds. Consequently, the Committee encouraged the SEC to distance itself altogether from a test that is based solely on financial capability and instead revamp the definition to incorporate concepts such as an individual’s professional experience, investment experience, education, credentials (series 7 securities license and the Chartered Financial Analyst designation), or even consider developing a financial-sophistication test that individuals may take. According to the Committee, this may be a more effective way, when compared to the current income and net worth tests, of “identifying a population of individuals who can fend for themselves without unnecessarily constraining the pool of capital available for private offerings.”

The SEC will review the Committee’s feedback and recommendations and then determine whether some or all of the recommendations, or a modified version of them, will actually be adopted in final rules.

We will continue to monitor any developments on this matter. If you have any questions concerning the subject matter of this alert, please do not hesitate to contact [Jayne Juvan](#) or [Ilirjan Pipa](#).

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