

## Changes to the Definition of “Accredited Investor”

### Can the SEC Promote Both Investor Protection and Access to Capital by Revising the “Accredited Investor” Definition?

By Cathryn Gawne

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the Securities and Exchange Commission (SEC) to review the definition of “accredited investors,” as it applies to natural persons, every four years to determine whether it should be adjusted for the protection of investors, in the public interest and in light of the economy. The SEC’s 2014 review is still in process, but a recent burst of rulemaking activity indicates that it may move forward before the end of 2015. If the SEC chooses to change the criteria by which individuals qualify as accredited investors, the primary question is whether such adjustment will focus on increased investor protection, potentially reducing the number of individuals who qualify as accredited investors, or on increased access to capital by potentially expanding the pool of qualified individuals.

#### Definition of Accredited Investor

The term “accredited investor” applies to those investors who presumably are not in need of protection and can “fend for themselves” in a private offering of securities. The definition as applied to natural persons has remained largely unchanged since the adoption of Rule 501 of Regulation D in 1982: any natural person (i) whose individual net worth, or joint net worth with that

person’s spouse, exceeds \$1,000,000, or (ii) who had an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person’s spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year. In 2010, the calculation of “net worth” was revised to exclude (except in certain limited instances) the value of an individual’s personal residence.

#### Advisory Committees Issue Diverging Recommendations

As part of its review, the SEC has received recommendations from two advisory committees: 1) the Advisory Committee on Small and Emerging Companies, formed to advise the SEC on capital raising by emerging privately held small businesses and small publicly traded companies (companies with less than \$250 million in public market capitalization), and 2) the Investor Advisory Committee, established by Dodd-Frank to advise the SEC on initiatives to protect investor

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interests, promote investor confidence and protect the integrity of the securities marketplace. The Committees issued somewhat divergent recommendations, based on different perceptions of problems caused by the current version of the “accredited investor” definition.

### **Investor Protection as Priority**

The Investor Advisory Committee focused on investor protection, stating that it believed “a significant percentage of individuals who currently qualify as ‘accredited investors’ are not in fact capable of protecting their own interests.” The Committee stated that the current financial thresholds for individuals are “highly imperfect proxies” for access to information, financial sophistication, and ability to withstand potential losses. It urged the SEC to revise the definition of “accredited investor” to more effectively define a class of individuals who do not need the protections provided by the Securities Act of 1933 in order to be able to make an informed investment decision and protect their own interests. The Committee objected to merely adjusting the net worth and income thresholds for inflation, as it did not know whether the original thresholds were reasonable when originally set in 1982. In addition, the Committee said that the SEC did not yet have sufficient data to calculate the impact of such an adjustment on the pool of capital available for private investments.

Instead, the Committee recommended that the SEC explore a number of alternatives, such as basing the definition on an individual’s financial assets or liquid assets (potentially excluding from this calculation certain types of assets such as retirement accounts). The Committee also suggested that in-

stead of focusing on net worth and income, the SEC consider restricting the percentage of assets or income that individuals could invest in private offerings. Another alternative presented by the Committee would allow individuals to qualify as accredited investors based on their financial sophistication (such as through professional credentials, investment experience, or a test of relevant financial knowledge), even if those individuals fail to meet the requisite financial thresholds.

### **Capital Formation as Priority**

The Advisory Committee on Small and Emerging Businesses gave priority to facilitating capital formation. The Committee urged the SEC to “do no harm” to the private offering ecosystem, noting that it found little or no evidence to suggest that the current definition had led to widespread fraud or other harm to investors and that any such changes could have a disparate impact on minority and women entrepreneurs. It recommended that any modifications to the definition should have the effect of expanding, not contracting, the pool of accredited investors, and gave three examples of how this might occur. First, the Committee recommended including within the definition those investors who met an undefined “sophistication test,” regardless of income or net worth. It also suggested that the current financial thresholds in the definition be adjusted according to the consumer price index, to address inflation. Finally, the Committee recommended that instead of tinkering with existing financial thresholds (which proposed modifications it called “of dubious value”), the SEC should focus on enhanced enforcement efforts and more investor education.

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**Effect of the Proposed Changes**

Each Committee’s recommendation plays to a different aspect of the SEC’s stated mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. In the past few years, the SEC has tried to satisfy a variety of constituencies by including both restrictive and expansive elements in proposed and final regulations (examples of this are the proposed crowdfunding regulations and the final version of Regulation A<sup>+</sup>, each of which attempts to expand the ability to raise capital but then layers over that a restrictive regulatory framework). We would not be surprised to see something similar in this case.

The SEC’s increased regulatory urgency could cause proposed changes to the “accredited investor” definition to be issued at any time. Contact your Montgomery & Hanson attorney to learn the latest developments.

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