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SEC Proposes Changes To Accredited Investor Standard And Assesses Its Impact On The Marketplace

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In December 2019, the Securities and Exchange Commission (the “**SEC**”) proposed amendments to the definitions of “*accredited investor*” and “*qualified institutional buyer*”. The securities laws use these definitions as important qualification standards for prospective investors in private offerings. As a qualification standard, the accredited investor definition is a core elements of several registration exemptions used by private companies when raising capital and, as a result, reduces compliance costs to help the market function efficiently. The proposed amendment follows a concept release provided by the SEC in June 2019 that set forth the SEC’s intent to update these definitions to improve the consistency, accessibility and effectiveness of the securities laws for the benefit of investors and issuers in the capital raising process.

PROPOSED CHANGES TO THE ACCREDITED INVESTOR QUALIFICATION STANDARD

Generally speaking, the proposed changes to the “*accredited investor*” definition could have significant positive implications for emerging company issuers (i.e., startups and other early stage private companies), as well as private funds. The proposed changes fall into two broader categories: (1) an expansion to new types of *natural persons* (i.e., individuals) and (2) an extension to new types of investment vehicles (i.e., entities).

Not surprisingly, the two most notable changes relevant to emerging companies expand the opportunities for a *natural person* to qualify as an accredited investor. As presently defined, among the more commonly used criteria for accredited investor status is:

- a natural person 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; or
- a natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds $1,000,000 (excluding the value of their primary residence).

The two specific, notable changes are, on the one hand, a new class of natural person who would be an accredited investor based on certain professional certifications and designations, such as a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution and, on the other hand, adding the concept of "spousal equivalent" for the purpose of determining an investors total income and/or net worth referenced in the current definition.

Spousal Equivalent. With respect to the proposed expansion to "spousal equivalent," the SEC noted the "uncertainties regarding whether persons in legally recognized unions, such as domestic partnerships, civil unions, and same-sex marriages, were considered spouses for purposes of the accredited investor definition." They further added that the SEC saw "no reason to distinguish between different types of relationship structures for the purpose of these rules and, in that regard… would remove unnecessary barriers to investment opportunities for spousal equivalents."

Sophisticated Professionals. Regarding natural persons with professional certifications, the SEC commented that "investors holding such certifications, designations and credentials may not meet the current financial thresholds in the accredited investor definition, and therefore the impact of investment losses on such investors could be significant." This comment is an important insight into the SEC's thinking and their general desire to help investors limit their overall risk. However, the proposal goes on to discuss the notion of financial sophistication, stating that it believes "the concept of financial sophistication encompasses not only an ability to analyze the risks and rewards of an investment but also the capacity to allocate investments in a way to mitigate or avoid risks of unsustainable loss." Professional certifications, it would seem in the SEC's perspective, would signal the ability to analyze one's own capacity to take losses.

SEC'S ROLE RELATIVE TO PROTECTING INVESTOR RISKS

Overall, the SEC views its role as follows: for investors it believes to be "unsophisticated," the SEC seeks to prevent such investors from taking too much overall financial risk by keeping them out of private company offerings altogether or putting a heightened burden onto issuers to provide enhanced disclosure to unaccredited investors (and thereby increasing compliance costs of doing so and making it less attractive to take in capital from unaccredited investors). Similar thinking underpinned many of the elements present in Regulation CF (Crowdfunding) that was geared toward making angel and early stage investing more accessible to a retail audience (an audience that the SEC undoubtedly views as "unsophisticated" and in need of their protection). However, for investors who the SEC views as "sophisticated," it is comfortable allowing them to make such a determination of their own, subject to having enough capital to lose and the ability to decide for themselves how much they can sustain losing.

THE GROWING MARKETPLACE AND THE IMPACT OF SECURITIES LAWS

To that end, it is also worth noting some of the empirical data referenced in the proposal. Specifically, that the total number of qualifying households (under the accredited investor definition) grew from 1.31 million in 1983 to 16 million in 2019. This data was presented in the context of the SEC choosing not to increase the above referenced income and net worth thresholds. The SEC clearly wants to expand the pool of available investors for private offerings and rightfully recognized that increases to the income or net worth thresholds would have a disruptive effect on the industry. Though the audience for private investment might have increased ten-fold in 35 years, it remains the benefit of the privileged few, relatively speaking. The SEC appears to have recognized this fact and doesn't appear keen on shrinking the available universe of investors.

The proposal also noted that “a sharp decrease in the accredited investor pool may result in a higher cost of capital for companies, particularly companies in regions of the country with lower venture capital activity who may rely on ‘angel’ or other individual investors as a primary source of funding.” Additional data was presented in the proposal regarding mean and median household income and net worth across various regional geographies, noting that it tended to be lower in the Midwest and South relative to the Northeast and West. The SEC correctly noted “adjusting the thresholds upward could curtail the ability of many financially sophisticated people in certain parts of the country from investing in local companies, about which they have first-hand knowledge.” With many geographies outside the coasts just starting to come online in terms of their venture capital and early stage ecosystems, reducing access to private offerings and markets would be incredibly damaging to the growth and proliferation of marketplace.

WHAT’S NEXT

Taken as a whole, the proposal provides a thoughtful assessment of the state of the securities law framework in question against the present state of affairs in private capital raising. The SEC remains focused on ensuring access to private markets for issuers and access to private offerings for investors. Yet, the balance between opening the gates too wide and the desire to protect investor downside remains at the forefront of their thinking. The SEC continues to request comment on the question of raising thresholds indicating that the issue has not been settled, but this most recent proposal, along with the highlighted data, suggests that the thresholds may not change any time soon.

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