SEC Staff Issues Report and Recommendations in Connection with Changes to the Accredited Investor Standard

On December 18, 2015 the SEC staff issued a report summarizing its review of the accredited investor definition. The report offers historical and current analyses of the definition, evaluates relevant comments on and suggested modifications to the definition, and considers alternative approaches under federal and state securities laws for identifying financially sophisticated investors. The report concludes with SEC staff recommendations for updates and modifications to the existing definition, and a brief impact analysis of the suggested approaches.

This report was mandated by the Dodd-Frank Act, which directs the SEC to review the accredited investor definition as it relates to natural persons every four years. The definition should identify those persons who, by nature of their financial sophistication and/or ability to withstand loss, do not require the protections provided by the Securities Act. The report notes that an overly narrow definition could limit the number of accredited investors, thereby restricting businesses' access to capital. An overly broad definition, on the other hand, would not adequately protect investors. The history of the definition also makes clear that clarity is key, and the definition should create bright-line tests that allow issuers to readily determine an investor's status.

As evidenced by prior public comments, some commenters feel that the definition is over-inclusive, primarily because the financial thresholds have never been adjusted for inflation. On the other hand, some commenters feel that the definition is under-inclusive, as certain financially sophisticated investors may not be sufficiently wealthy.

The current threshold tests, adopted in 1982, bestow accredited investor status on (1) any natural person whose individual income exceeded $200,000 in each of the two most recent years (or $300,000 in joint income with that person's spouse), and who reasonably expects to reach the same level in the current year; (2) any natural person whose net worth (individually or jointly with a spouse) exceeds $1 million, excluding the value of their primary residence; and (3) certain enumerated entities with over $5 million in assets. Since 1982, the test has only been changed to exclude an investor's primary residence from the net worth threshold and by adding a joint income option.

As previously noted, the thresholds have not been adjusted for inflation since their adoption in 1982 although the value of an investor's primary residence was excluded 2011. In 1983, 1.51 million U.S. households qualified as accredited investors, representing approximately 1.8% of all U.S. households. Today, 12.38 million U.S. households qualify, representing approximately 10.1% of U.S. households. For reference, if adjusted to account for inflation today, the thresholds under the individual income, joint income, and net worth tests would balloon to $490,819, $600,558, and $2,454,093, respectively, and only 3.6% of U.S. households would qualify.

The Recommendations:

The staff offers a number of recommendations for the SEC to consider, all or any combination of which could be implemented concurrently. These recommendations are broadly separated into two categories: (1) revisions to the financial thresholds for natural persons and the list-based approach for entities to qualify as accredited investors; and (2) revisions to the definition to allow individuals to qualify based on other measures of investing and financial sophistication and knowledge.

1. Recommendations Relating to Financial Thresholds for Individuals and Entities:

- Maintain the current income and net worth thresholds, subject to investment limitations.

- Investors that qualify under the current standard, but not the higher inflation-adjusted thresholds outlined below, would only be able to invest a percentage of their income or net worth (for instance, 10% of prior year income or 10% of net worth, per issuer, in any 12-month period).

- Create new inflation-adjusted income and net worth threshold that is not subject to investment limitations.

- The staff suggests inflation-adjusted thresholds of $500,000 (individual income), $750,000 (joint income), and $2.5 million (net worth). Investors meeting these standards would not be subject to the above investment limitations.

- Index all financial thresholds in the definition for inflation on a going-forward basis.

- The staff suggests adjusting the thresholds to account for inflation every four years.

- Permit spousal equivalents to pool their finances for the purpose of qualifying as accredited investors.

- The staff suggests adding the term “spousal equivalent” to the definition, thus providing consistent treatment among marriages, civil unions, and domestic partnerships.

- Permit entities with investments in excess of $5 million to qualify as accredited investors.

- Currently only certain enumerated entities may qualify as accredited investors. LLCs, Indian tribes, labor unions, and many other entities are offered no mechanism to qualify. Additionally, only entities with “assets” above $5 million may qualify.

- The staff suggests modifying the definition to permit any entity with “investments” in excess of $5 million, and not formed for the specific purpose of investing in the securities offered, to qualify as an accredited investor. The term “investments” would be defined based on the definition used in Investment Company Act Rule 2a51-1(b).

- Grandfather an issuer’s existing investors that meet and continue to meet the current definition with respect to future offerings of the issuer’s securities.

- This narrow addition would provide protection from dilution for those investors who would no longer be accredited under the new definition.

2. Recommendations Relating to Investor Sophistication and Knowledge:

- Permit individuals with a minimum amount of investments, who are not now fall within the standard, to qualify due to their experience in investing.

- No specific threshold is proposed, although they seem to favor $750,000. The SEC proposed adding a $750,000 "investments-owned" standard in 2007, and the staff assumes this value in its impact analysis.

- "Minimum investments" as defined in Investment Company Act Rule 2a51-1(b)).

- Permit individuals with certain professional credentials to qualify as accredited investors, such as, for example, those who have passed the Series 7, Series 65, or Series 82 exam.

- Permit individuals with experience investing in exempt offerings qualify.

- Individuals who have invested in at least ten private securities offerings, each conducted by a different issuer. The staff suggested the ten offering threshold after noting that, on average, current angel investors have invested in at least ten private offerings.

- Permit knowledgeable employees of private funds to qualify as accredited investors for investments in their employer's funds.

- Allow "knowledgeable employees" of "covered companies" to qualify as accredited investors. The staff would apply the relevant definitions found in Rule 3c-5 of the Investment Company Act.

- This would expand the category of accredited investors which includes now only includes directors, executive officers, or general partners of an issuer to encompass any "knowledgeable employee" such as a trustee, advisory board member (or person serving in a similar capacity), and employees of the manager/fund who participate in investment activities.

- Permit individuals who pass an accredited investor exam to qualify.

- The exam would test an individual's financial and investing knowledge and understanding of private offerings and the relevant risks. Certain portions of the Series 7 and Series 82 exams cover these areas, and could serve as a model for the exam.