

Management Alert



Recommended Changes to “Accredited Investor” Definition Adds Complexity to Private Financing

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On October 9, 2014, the Investor Advisory Committee (the “Committee”) of the Securities and Exchange Commission (“SEC”) released a series of recommendations concerning the definition of “accredited investor” that, if adopted, are likely to have a significant impact on the manner in which start-ups and other companies raise capital in private transactions.

Background

The Securities Act of 1933 divides the world of capital raising into public and private offerings. Public offerings must be accompanied by extensive disclosures in a registration statement filed with the SEC and frequent updates regarding material information about the issuer. Absent an exemption from registration, every securities transaction that involves interstate commerce must be registered with the SEC. Transactions “not involving a public offering” are exempt from the registration requirements; and, other than refraining from committing fraud, issuers in private offerings are typically only required to provide a limited amount of information to investors.

Generally, offering exemptions for sales of securities to investors who are “accredited investors” are the least restrictive and have the fewest information requirements because these types of investors are thought to be best able to “fend for themselves” and thus do not require the protections mandated by the SEC for securities offered to the general public. In theory, accredited investors in private transactions protect their own interests by negotiating with the issuer on issues such as valuation and pricing, disclosure, and board representation.

Under Rule 506 of SEC Regulation D, which establishes specific rules for private offerings, issuers can seek financing from an unlimited number of “accredited investors” without having to submit to the public registration and disclosure rules. Under the current framework, an individual “accredited investor” is someone who either (i) had individual annual income in excess of \$200,000 (or joint annual income together with his or her spouse in excess of \$300,000) in each of the two most recent years and reasonably expects to achieve such income in the current year, or (ii) has a net worth in excess of \$1,000,000 (excluding his or her primary residence). These financial thresholds are intended to be “proxies” indicating that investors with those levels of income or net worth have the sophistication to obtain and evaluate information about the issuer and to bear the risks of the investment where there is no public market for liquidity.

Committee Findings

In its October 2014 recommendations, the Committee argued that the current income and net worth standards are at best imperfect proxies for the ability to make an informed investment decision and the ability to withstand losses. The Committee - formed under the Dodd-Frank Wall Street Reform and Consumer Protection Act to advise the SEC on initiatives to protect investor interests and consisting of thought leaders in the securities industry - observed that:

- Although there may be some correlation between income or net worth and financial literacy, a significant number of wealthy

investors would fail a test for financial literacy while other investors may have greater sophistication but lower incomes or net worth.

- An investor who meets the net worth test may not have sufficient liquid assets to hold a privately issued security indefinitely or be able to bear loss of the investment. For example, an investor in need of cash would be forced to sell assets such as a family business if they hold large amounts of illiquid securities from private offerings, or would have to tap into retirement savings to fund current living expenses.
- The net worth and income tests do not differentiate among individuals who may be heavily invested in private securities and bear significantly greater risk than those who have a more diversified portfolio that includes public company stocks or other liquid assets.
- The dollar thresholds of \$200,000 (or \$300,000 for a married couple) in income or \$1,000,000 of net worth may have represented substantial wealth when adopted in 1982, but are not necessarily comparable in 2014 dollars. Adjusted for inflation, the income threshold today would be about \$500,000 for an individual or \$740,000 for a married couple, and the net worth test would be almost \$2,500,000.

Committee Recommendations

In light of these observations, the Committee recommended that the SEC should:

- Consider a more nuanced test for investor sophistication. Rather than simply raising the dollar thresholds for income and net worth to adjust for inflation, the standards should require that the investor have appropriate amounts of financial or other liquid assets, excluding retirement accounts (and should include a prohibition against circumventing the rule by using retirement savings to fund private investments).
- Develop a mechanism for investors to demonstrate that they are sophisticated, including through professional credentials, investment experience or a test of financial knowledge.
- Consider limiting how much an accredited investor can invest in private securities. Currently, anyone who meets the test of an accredited investor can invest all of their assets in private offerings, thus putting their entire financial security at significant risk.
- Encourage alternative means of verifying accredited investor status, so that the burden does not fall exclusively on issuers (who may be poorly equipped to take on this task) and gives investors a degree of confidentiality (which would be especially important if the accredited investor test requires more detailed information from investors). Alternatives might include using reliable third parties, such as brokers or other professionals skilled in collecting and holding this information, to verify accredited investor status.
- Prohibit the practice of allowing an individual to qualify as an accredited investor based on the sophistication of his or her “purchaser representative” unless the representative is entirely independent of the issuer and the transaction and is devoted only to the best interests of the investor.

Conclusion

The Committee’s recommendations reflect an interesting tension between the SEC’s mission of protecting investors by updating the accredited investor standards while at the same time being tasked by Congress to proceed with crowdfunding initiatives designed to permit significantly broader participation in the securities markets. It remains to be seen how the SEC will reconcile these seemingly conflicting policy objectives. Because private securities offerings now comprise a trillion dollar market, with the majority of those funds raised under Rule 506, we can expect that the issue will remain a high priority for the SEC.

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