

Proposed Changes to SEC Accredited Investor Definition-- What Was Left Out?

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The long-awaited Securities and Exchange Commission (SEC) action may now soon occur to revise (Changes) the accredited investor definition (Definition). In a release (Release)¹, the SEC proposes amending that Definition in several ways. However, the Changes are significant in what they do not include.

Scope of Changes—

Primarily, the Changes are to rules adopted pursuant to the Securities Act of 1933, as amended (Act). They also impact Definitional-use in rules of other federal laws (Other Federal Laws).

Enumeration. Changes consist of the following:

- Adding new Definitional-categories for qualifying natural persons and entities (Purchasers).
- Modifying certain aspects in the existing Definition.
- Making changes to the qualified institutional buyer definition associated with the Act.

Public Comment Period; Release Size. The Release seeks public comment on the Changes through March 15, 2020. The SEC may proceed to final rule adoption after that date.

The Release is over 150 pages long and contains almost 200 questions seeking comments on specific Changes.

Expansion of Purchaser-Categories. The Release states the Changes focus on Definitional-improvements. In so doing, the Changes are to identify more effectively institutional and individual investors having knowledge and expertise allowing participation in United States private capital markets (PC Markets) without benefit of additional protection.

The Release proffers that protection would be provided through Act-registration of underlying securities offerings.

To accomplish this focus, the Changes add the following new Purchaser-categories (regardless of the persons' respective wealth) and make other adjustments to existing Definitional-categories:

- Natural person qualifying based upon professional certification, designation or other certification from accredited educational institutions.
- Natural person qualifying as a knowledgeable employee in a private fund, as regulated under Other Federal Laws.
- Entities qualifying under conditions of rules adopted under, and family offices and family clients as defined by rules under, Other Federal Laws; and other persons qualifying as addressed in interpretive positions of SEC staff.

- Person qualifying as a spousal equivalent, so the person may pool finances (same as a spouse) for purposes of satisfying the Definition's net worth calculation.

It is not the intent in this article to go into detail on the effect of the Changes on Other Federal Laws. The following is a brief discussion of some aspects of what was omitted from the Changes and their possible effect on state securities law.

Bi-Level Securities Regulation—

Federal and State Levels. Offers and sales of securities in the United States (Offerings) are regulated at federal and state levels. Under the Act, an Offering must be registered, with limited exception. The exception is where the security or its Offering is exempted from registration. However, registration exemption does not shield the issuer from anti-fraud provisions of the Act, i.e., requirements of full disclosure of material facts related to the Offering.

A similar approach to Offering regulation is followed by many states. For example, Alaska's Offering regulation is accomplished through the Alaska Securities Act (AS 45.56, Alaska Act). The Alaska Act replaced a previous act (which had been in place since statehood), becoming effective on January 1, 2019.

Regulation D, Rule 506. One of the registration exemptions under the Act centers on private Offerings. That exemption is further described by regulation (Regulation D). It was first adopted by the SEC in 1982.

One of the regulatory approaches under Regulation D is Rule 506. Under Rule 506, a private Offering is limited to no more than 35 non-accredited investors. While imposing no limit on the number of accredited investors in a Rule 506 Offering, the rule has other prerequisites for reliance on it.

Subsequent to that SEC administrative action, many states, including Alaska, adopted regulations providing parallel Offering regulatory paths. In 1996, the Act was amended to preempt state registration law relating to Rule 506 Offerings (Rule 506 Preemption).

Rule 506 Preemption does allow a state to require a notice filing and payment of a notice filing fee relating to a Rule 506 Offering done within that state's jurisdiction (Notice Provisions). In administering the Alaska Act, the state requires Notice Provisions.

Policy Issue Bases for Changes—

Effect of Unregistered Offerings on PC Markets. The Release notes unregistered Offerings are significant for capital formation in PC Markets. It states, in 2018, such Rule 506 Offerings were used in PC Markets to raise \$1.7 trillion, as compared to \$1.4 trillion being raised in Act-registered Offerings. The Release concludes accredited investors are critical in providing capital in PC Markets.

Investor Protection. The Release states the SEC considered investor protection in assembling the Changes. It notes this protection includes ability of the investor to participate in, and supply capital to, PC Markets.

The Release proffers the SEC considered the effect of an overly broad Definition, i.e., that which undermines investor protection and reduces public confidence in PC Markets. It also states that the SEC

considered the effect of an unnecessarily narrow Definition, i.e., that which limits investor access to investment opportunities.

Wealth Thresholds Left Untouched. The current Definition provides eight categories in which a person may qualify as an accredited investor. Of these categories, a natural person may qualify based upon satisfying one or more financial thresholds (Wealth Thresholds), as proxies for financial sophistication. While the Release goes to considerable length in identifying ways to increase the scope of persons included in the Definition, it leaves existing monetary levels of Wealth Thresholds untouched.

Wealth Thresholds include a natural person's having annual income in excess of \$200,000 per year (or \$300,000 with spouse (or, with the Changes adopted, spousal equivalent)) in each of the two most recent years prior to the Offering and reasonable expectation of reaching that income level in the year of the Offering. Wealth Thresholds also include, as an alternative qualification, the natural person's having net worth in excess of \$1 million (with specific exclusions from that net worth calculation).

The Release argues investors today have greater accessibility to information and advances in technology to acquire information than in the past. These changes include the rise in use of the internet, social media and other forms of communication. It proffers information about issuers and other participants in PC Markets is presently more readily available to a wide-range of market participants.

The Release states the SEC was not aware of widespread problems or abuses associated with Regulation D Offerings to investors. Finally, it notes the Definition has been amended three times since initial adoption. While Wealth Thresholds have essentially remained unchanged, the SEC concludes it is not necessary or appropriate to modify them as a part of the Changes.

Possible Effect of Unchanged Wealth Thresholds--

The Release acknowledges it might be argued an investor with wealth at the Wealth Thresholds in 2019 would not be as wealthy as such investor would have been in 1982. However, it also argues Wealth Thresholds still exceed by a large margin current mean and median household income and household net worth in all regions of the country.

How might the SEC decision to decline changing Wealth Thresholds affect Regulation D Offerings in Alaska?

At present, the Alaska Regulation D relies directly upon the provisions of the federal Regulation D, especially in the context of the Definition. Rule 506 Preemption, in allowing states only Notice Provisions, severely limits the manner in which states may regulate Rule 506 Offerings.

As of the date of this article, Alaska had not adopted regulations interpreting the Alaska Act. At that time, the state continued reliance upon regulations adopted under its previous securities law in administering the Alaska Act.

Wealth Thresholds used as proxies for sophistication may not be the better way to measure investor financial-fitness for high risk ventures in the PC Market. Wealth Thresholds remaining unchanged by the SEC may present a challenge for Alaska in administering the Alaska Act.

Summary—

Effort by the SEC on Changes are broad in scope. However, the SEC chooses, for various reasons, including demographics and, in its view, lack of abuse of accredited investors in Regulation D Offerings, not to adjust the Wealth Thresholds.

While this article covers some Changes in limited fashion, a prudent practitioner, in advising an issuer of, or Purchaser in, a Rule 506 Offering or otherwise in reliance upon status of an investor as an accredited investor, ought to become familiar with all Changes and that which may eventually become SEC final rules.

Good luck on your read of the Release!

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¹ “Amending the ‘Accredited Investor’ Definition,” SEC Release Nos. 33-10734, 34-87784; File No. S7-25-19, RIN 3235-AM19; December 18, 2019.

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