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## SEC Receives Recommendations on Changes to Accredited Investor Definition

*United States Emerging Growth and Venture Capital Alert**By Gary J. Kocher, Eric D. Jay*

On October 9, 2014, the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) held a meeting of its Investor Advisory Committee (the “AC”) to discuss recommendations from the AC subcommittees, including recommendations on new standards for the definition of “accredited investor” for natural persons. The subcommittees discussed several potential changes for improving the definition of accredited investor in their recommendations. Rather than simply suggest increasing the financial thresholds for accredited investor status<sup>1</sup>, the subcommittees urged the Commission to consider alternative criteria that serve as more accurate proxies for meeting the underlying objectives identified by the U.S. Supreme Court in its 1953 *Ralston-Purina* decision for defining the class of investors that have sufficient financial sophistication, access to information or ability to withstand investment loss to justify an exemption from the protection of the Securities Act of 1933.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which established the AC, requires the SEC to undertake a review of the accredited investor definition every four years. The current income and net worth standards in the definition were set in 1982 and some argue they have been eroded by inflation. Had the thresholds been adjusted for inflation, the income threshold today would be approximately \$500,000 (\$740,000 for a married couple) and the net worth threshold would be nearly \$2.5 million.

Even if the financial thresholds were increased, the subcommittees argued that several distinct disadvantages would remain. Specifically, using binary income and net worth thresholds: (1) includes investors that lack necessary financial sophistication while excluding many of those who do possess such sophistication; (2) ignores whether investors have sufficient liquid financial assets to withstand potential losses; (3) includes retirement savings that are relied on for regular income; and (4) ignores the percentage of income or assets that may be invested by an accredited investor in private offerings, meaning investors just under the threshold are excluded entirely while investors that satisfy the thresholds are permitted to invest as much of their income or assets as they please, with no limitations inbetween. The subcommittees recognized that increasing the financial thresholds for inflation would significantly restrict the pool of capital available to private offerings without addressing these issues in a meaningful way.

To combat these inadequacies, the subcommittees proposed two key recommendations: (1) the SEC should revise the accredited investor definition to enable individuals to qualify based on their financial sophistication, and (2) to the extent financial thresholds remain in use, the SEC should consider limiting the percentage of income or assets that may be invested in

<sup>1</sup> Under the current definition of Accredited Investor, an individual must have (i) annual income of at least \$200,000 (or \$300,000 jointly with spouse) in each of the two most recent years and an expectation of such income in the current year or (ii) net worth (excluding the value of the investor’s primary residence) of \$1.0 million or more.

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private offerings over a set period of time. By implementing these changes, they argued, the SEC could maintain the current financial thresholds while both increasing the pool of capital available to private offerings and improving investor protections. Potential examples for satisfying the financial sophistication threshold included professional credentials/certifications, relevant professional and investment experience, participation in angel groups that follow best practices, as well as the establishment of a potential standardized test. The subcommittees also made two additional recommendations regarding protections for private offerings generally: (1) the SEC should take meaningful steps to develop an alternative means of verifying accredited investor status that shifts the burden away from issuers, and (2) the SEC should strengthen protections for non-accredited investors who qualify by relying on advice from a purchaser representative. The subcommittees recognized that any change to the accredited investor definition that increases its complexity will ultimately increase the burden on issuers to verify accredited investor status. Third-party verification provided by securities professionals, such as brokers, accountants and attorneys, was proposed as one potential solution.

Many different constituencies in the investment community have a keen interest in the outcome of this important rule-making process. The subcommittees were careful to note that certain approaches to the issue could result in a significant constraint on the availability of funding for start-up and other private companies. The AC recommendations are crafted in such a way as to seek to balance these considerations and potentially to enlarge the pool of capital available to private issuers. However, the issue will be whether the proposals, which move away from easily verifiable objective criteria toward more complexity that involves the intervention of a third-party verifier, will prove to be workable solutions for the investment community.

The subcommittees' recommendations were approved by the AC in full and formally submitted to the SEC for its consideration. The SEC is still in the process of taking comments on the issue and has not given any indication of when a proposed rule may be forthcoming.

For those wanting further information on this topic, feel free to contact the authors of this Alert. The full text of the recommendations adopted by the AC can be found [here](#).

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