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SEC to Revise “Accredited Investor” Definition — for Better or Worse?

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Any changes to the “accredited investor” definition should balance the SEC’s two primary (but competing) goals of protecting investors and encouraging capital formation for small businesses. One proposal has been to simply adjust the thresholds in the definition for inflation. For example, the GAO Report noted that adjusting the $1 million net worth threshold for inflation to $2.3 million would decrease the number of qualifying households from approximately 8.5 million to 3.7 million. Some commentators have panicked that such a reduction in the number of eligible accredited investors would have a substantial negative impact on private investment in the United States. On its face, one can see the cause for alarm — but what the GAO Report does not tell us is what percent of funding by accredited investors has historically been provided by those that would no longer be eligible after adjusting the thresholds for inflation. It seems quite likely that a 60 percent decrease in eligible households would result in a drastically smaller decrease in funds provided by accredited investors, on the assumption that smaller accredited investors have historically provided a smaller percent of capital raised. Still, many have argued that existing thresholds are sufficient (noting, for example, the limited claims of investor fraud in the private placement market) and that any increase will discourage growth at a time when the economy is still rebounding.

Though the GAO Report cites net worth as the most important criteria for determining accredited investor status (based on, in part, its indication of an investor’s ability to absorb loss and presumed sophistication), the report did note other potential modifications to the definition that the SEC may consider, including, among others, (i) a liquid investments requirement (i.e., a minimum dollar amount of investments that can be easily sold and whose value can be verified), (ii) use of a registered investment adviser, and (iii) self-certification, licensing or other education standards to establish investor sophistication (e.g., attorneys and certified public accountants may be deemed to be accredited investors), in each case in addition to, or in lieu of, existing requirements. Requiring $250,000 of a person's net worth to be liquid would certainly protect investors by making sure they can better absorb potential losses, but would come at the cost of reducing the number of eligible accredited investors and thus available capital. Requiring use of a registered investment adviser or establishing other sophistication criteria (in the absence of other financial requirements) may result in new eligible accredited investors and available capital, but may result in investors participating in private placements who are unable to withstand potential significant losses.

While the SEC ruminates on possible revisions to the accredited investor definition and the investment community waits with bated breath, small businesses should also keep in mind the coming final rules (the comment period ended March 24, 2014) establishing the new regime under Regulation A pursuant to the JOBS Act (commonly referred to as Regulation A+). Regulation A+ will increase the cap for the infrequently-used Regulation A from $5 million to $50 million as a middle road for private companies to raise larger amounts of capital without going public. Whether the SEC views this current opportunity to tighten the definition of "accredited investor" as a way to encourage market acceptance of Regulation A+ (which unlike private placements does involve certain disclosure and ongoing reporting obligations) is an open question. See everyone in July.

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