

Stradley Ronon Stevens & Young, LLP  
2005 Market Street  
Suite 2600  
Philadelphia, PA 19103-7018  
215.564.8000 Telephone  
215.564.8120 Facsimile  
www.stradley.com

With other offices in:  
Washington, D.C.  
Malvern, Pa.  
Harrisburg, Pa.  
Wilmington, Del.  
Cherry Hill, N.J.  
New York, N.Y.



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## Summary of the SEC’s Report on the Review of the Definition of ‘Accredited Investor’

*by Prufesh R. Modhera and Peter Tsirigotis*

On Dec. 18, 2015, the staff of the Securities and Exchange Commission issued its Report on the Review of the Definition of “Accredited Investor” (the Report). The Dodd-Frank Wall Street Reform and Consumer Protection Act directs the SEC to review every four years the definition of “accredited investor” as it relates to natural persons to determine whether the definition should be modified or adjusted for the protection of investors, in the public interest and in light of the economy.

The Report itself is a very useful summary of the private placement exemption, the pros and cons of the current definition of accredited investor, and the pros and cons of any revisions to the current definition of accredited investor.

### Background

Section 4(a)(2) of the Securities Act of 1933, as amended (the 1933 Act), exempts “transactions by an issuer not involving any public offering” (private offering) from the registration and reporting requirements of Section 5 of the 1933 Act. The 1933 Act did not define what constitutes a private offering. In *SEC v. Ralston-Purina*, the Supreme Court stated that whether a transaction was public did not hinge on just the limitation of scope of the pool of offerees, but whether the pool of offerees “affected need[ed] the protection of the [1933] Act. An offering to those who are shown to be able to fend for themselves is a ‘transaction not involving any public offering.’” In identifying an example of a class of offerees who could fend for themselves, the Supreme Court cited “executive personnel who because of their position have access to the same kind of information that the [1933 Act] would make available in the form of a registration statement.”

In response to the Supreme Court’s decision, the SEC promulgated Regulation D under the 1933 Act in an attempt to define a pool of investors referenced in the Supreme Court’s decision. Regulation D established a nonexclusive safe harbor. Transactions conducted in compliance with this safe harbor would be deemed to not affect natural persons or entities that needed the protection of the 1933 Act.

*(continued)*

One of the types of transactions is an offering to “accredited investors.” Accredited investors are deemed to be sufficiently “sophisticated” and are capable of fending for themselves such that the protections of the 1933 Act are not needed. In promulgating Regulation D, the SEC used natural persons’ income and wealth as a proxy in determining that persons could fend for themselves and gain access to the same level of information as if the protections of the 1933 Act were provided.

Rule 501(a) of Regulation D under the 1933 Act defines an accredited investor as a natural person who 1) has a net worth or joint net worth with his or her spouse in excess of \$1,000,000 (excluding their primary residence)<sup>1</sup> on the date of purchase; or 2) had an income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and who reasonably expects an income of the same level in the current year. Rule 501(a) of Regulation D also defines accredited investors to include certain listed entities, some of whom are required to meet an asset-based test.

In 2013, Regulation D was revised to allow a general solicitation (public announcement) of securities without registering under Section 5 of the 1933 Act, provided that all the investors who purchase the securities are accredited investors.

### Issue

The income and net worth standards were set by the SEC in 1983.<sup>2</sup> Congress, the SEC and members of the public have questioned whether the more than 30-year-old standard has become outdated. Since that time, inflation has increased the number of natural persons who qualify under the definition of accredited investor. In addition, other social and economic changes have occurred that do not fit neatly within the definition of accredited investor for both natural persons and entities. As an example, the SEC cited the use of limited liability companies, which is not specifically identified in Rule 501(a) of Regulation D.

### Recommendations

In the Report, the staff of the SEC made a series of recommendations to the SEC Commissioners for their consideration. The main recommendations are to 1) revise the current financial thresholds for natural persons; and 2) allow for other forms of proof of investor sophistication. While the purpose of the Report was to review the



*Prufesh R. Modhera*



*Peter Tsirigotis*

*For more information, contact Prufesh R. Modhera (pmodhera@stradley.com or 202.419.8417) or Peter Tsirigotis (ptsirigotis@stradley.com or 202.292.4528).*

definition of accredited investor for natural persons, the staff also included additional recommendations regarding the definition of accredited investor for entities:

1. The Commission should revise the financial threshold requirements for natural persons to qualify as accredited investors and the list-based approach for entities to qualify as accredited investors. The Commission could consider the following approaches to address concerns with how the current definition identifies accredited investor natural persons and entities:
  - Leave the current income and net worth thresholds in place, subject to investment limitations.
  - Create additional inflation-adjusted income and net worth thresholds that are not subject to investment limitations.
  - Index all financial thresholds for inflation on a going-forward basis.
  - Permit spousal equivalents to pool their finances for purposes of qualifying as accredited investors.
  - Revise the definition as it applies to entities by replacing the \$5 million assets test with a \$5 million investments test and including all entities rather than specifically enumerated types of entities.
  - Grandfather issuers’ existing investors that are accredited investors under the current definition with respect to future offerings of their securities.

2. The Commission should revise the accredited investor definition to allow individuals to qualify as accredited investors based on other measures of sophistication. The Commission could consider the following approaches to identify individuals who could qualify as accredited investors based on criteria other than income and net worth:

- Permit individuals with a minimum amount of investments to qualify as accredited investors.
- Permit individuals with certain professional credentials to qualify as accredited investors.
- Permit individuals with experience investing in exempt offerings to qualify as accredited investors.
- Permit knowledgeable employees of private funds to qualify as accredited investors for investments in their employer's funds.
- Permit individuals who pass an accredited investor examination to qualify as accredited investors.

While the above are the SEC staff's recommendations to the Commission, the SEC staff did not state that they found the current definition of accredited investor to be not

protective. It is interesting to note that the SEC staff did not recommend the elimination of the accredited investor definition, but rather recommended modifications to the existing standards.

Many of the proposals above (e.g., allowing individuals to qualify as accredited investors based on other measures of sophistication) have been discussed for years, without any formal rule proposals. In addition, the SEC staff hinted that if the current definition of accredited investor is not revised, it should be coupled with a minimum investment amount or a limit on how much of a person's net worth may be invested within a 12-month period. However, it is still too early to predict which recommendations the Commission will decide to implement or how long it would take to implement them. In addition, the Commission is currently composed of only three persons. With two additional individuals to be appointed, and depending on who those appointees are, any proposed rules may deviate from the recommendations in the Report.

<sup>1</sup> Note: If the liability of a person's residence exceeds the value of the residence, then that excess liability must be subtracted from that person's net worth calculation.

<sup>2</sup> The joint income standard of \$300,000 was set by the SEC in 1988.

## Private Investment Funds Practice Group

Fabio Battaglia III.....	215.564.8077 .....	fbattaglia@stradley.com
Mitchell M. Brand.....	212.812.4126 .....	mbrand@stradley.com
Brian Crowell .....	215.564.8082 .....	bcrowell@stradley.com
Matthew R. DiClemente .....	215.564.8173 .....	mdiclemente@stradley.com
Ruth S. Epstein.....	202.292.4522 .....	repstein@stradley.com
Alan R. Gedrich .....	215.564.8050 .....	agedrich@stradley.com
Shawn A. Hendricks .....	215.564.8778 .....	shendricks@stradley.com
Peter M. Hong.....	202.419.8429 .....	phong@stradley.com
Nathan M. Iacovino .....	215.564.8164 .....	niacovino@stradley.com
David H. Joseph.....	215.564.8090 .....	djoseph@stradley.com
Kevin P. Kundra.....	215.564.8183 .....	kkundra@stradley.com
Kristin M. McKenna.....	215.564.8145 .....	kmckenna@stradley.com
Prufesh R. Modhera .....	202.419.8417 .....	pmodhera@stradley.com
William S. Pilling III.....	215.564.8079 .....	wpilling@stradley.com
Jessica Rickman .....	202.419.8423 .....	jrickman@stradley.com
Christopher C. Scarpa .....	215.564.8106 .....	cscarpa@stradley.com
Gary P. Scharmatt.....	215.564.8046 .....	gscharmatt@stradley.com
Nicole Simon .....	215.564.8001 .....	nsimon@stradley.com
Lawrence P. Stadulis .....	202.419.8407 .....	lstadulis@stradley.com
Peter Tsirigotis .....	202.292.4528 .....	ptsirigotis@stradley.com
Ranan Z. Well.....	202.419.8404 .....	rwell@stradley.com