
Report on the Review of the Definition of “Accredited Investor”



This is a report by the staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings or recommendations contained herein.

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REPORT ON THE REVIEW OF THE DEFINITION OF “ACCREDITED INVESTOR”

I. Introduction

A. Background

Absent an available exemption, the Securities Act of 1933 (the “Securities Act”) requires that offers and sales of securities be registered with the Securities and Exchange Commission (the “Commission”). Registration is intended to provide investors with full and fair disclosure of material information so that they are able to make their own investment decisions.¹ Congress, however, recognized that in certain situations there is no practical need for registration or the public benefits from registration are too remote.² Accordingly, the Securities Act contains a number of exemptions to its registration requirements and authorizes the Commission to adopt additional exemptions. The exemptions in Regulation D³ are the most widely used transactional exemptions for securities offerings by issuers. Issuers using these exemptions raised over \$1.3 trillion in 2014 alone, an amount comparable to what was raised in registered offerings.⁴

¹ See, e.g., Commissioner Francis M. Wheat, *Disclosure to Investors - A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts* (Mar. 1969) (often referred to as the “Wheat Report”).

² H.R. Rep. No. 73-85 (1933).

³ Regulation D – Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 CFR 230.500 through 230.508.

⁴ See Scott Bauguess, Rachita Gullapalli and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014* (Oct. 2015) (the “Unregistered Offerings White Paper”), available at <http://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf>. Underlying data in the Unregistered Offerings White Paper was obtained from Form D filings. While Rule 503 of Regulation D (17 CFR 230.503) requires the filing of a notice on Form D no later than 15 days after the first sale of securities, the filing of a Form D is not a condition to a Regulation D safe harbor or exemption. Consequently, it is possible that some issuers do not make Form D filings for offerings relying on Regulation D and the available data on Regulation D offerings could underestimate the actual amount of capital raised through those offerings.

B. Accredited Investor Definition

The “accredited investor” definition is a central component of Regulation D. It is “intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.”⁵ Qualifying as an accredited investor is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by hedge funds, private equity funds and venture capital funds. Issuers of unregistered structured finance products and debt securities also may rely on Regulation D. Investors in unregistered offerings can be subject to investment risks not associated with registered offerings because some securities law liability provisions do not apply to private offerings, issuers of unregistered securities generally are not required to provide information comparable to that included in a registration statement and Commission staff does not review any information that may be provided to investors in these offerings.⁶

Regulation D originated as an effort to facilitate capital formation, consistent with the protection of investors, by simplifying and clarifying existing rules and regulations, eliminating unnecessary restrictions those rules and regulations placed on issuers, particularly small businesses, and achieving uniformity between federal and state exemptions.⁷ While it is

⁵ Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015] (the “Regulation D Revisions Proposing Release”).

⁶ See, e.g., SEC Office of Investor Education and Advocacy, *Investor Alert: Private Placements Under Regulation D* (Sept. 24, 2014), available at http://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

⁷ See Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389 (Mar. 8, 1982) [47 FR 11251] (the “Regulation D Adopting Release”).

particularly useful for small businesses, issuers of all sizes conduct offerings in reliance on Regulation D, in general, and Rule 506(b)⁸ in particular.⁹ Under the accredited investor definition, natural persons are accredited investors if their income exceeds \$200,000 in each of the two most recent years (or \$300,000 in joint income with a person’s spouse) and they reasonably expect to reach the same income level in the current year.¹⁰ Natural persons are also accredited investors if their net worth exceeds \$1 million (individually or jointly with a spouse), excluding the value of their primary residence.¹¹ Certain enumerated entities with over \$5 million in assets qualify as accredited investors,¹² while others, including regulated entities such as banks and registered investment companies, are not subject to the assets test.¹³

In addition to being a historical cornerstone of Regulation D, the accredited investor definition plays an important role in other federal and state securities laws contexts and has taken on increased significance as a result of the Jumpstart Our Business Startups Act (the “JOBS Act”).¹⁴ For example, the JOBS Act required the Commission to revise Rule 506¹⁵ to permit general solicitation and general advertising in offerings where all purchasers are accredited

⁸ 17 CFR 230.506(b).

⁹ *See* Unregistered Offerings White Paper.

¹⁰ 17 CFR 230.501(a)(6).

¹¹ 17 CFR 230.501(a)(5).

¹² 17 CFR 230.501(a)(1), (3) & (7).

¹³ 17 CFR 230.501(a)(1), (2) & (8).

¹⁴ Pub. L. No. 112-106, 126 Stat. 306 (2012).

¹⁵ 17 CFR 230.506.

investors and the issuer takes reasonable steps to verify their accredited investor status.¹⁶ In addition, the accredited investor definition served as a model for an exemption under the Uniform Securities Act of 2002.¹⁷

C. Reasons for the Report

Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)¹⁸ directs the Commission to review the accredited investor definition as it relates to natural persons every four years 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. Section 413(b)(2)(A) specifies that this review shall be conducted not earlier than four years after enactment of the Dodd-Frank Act and no less frequently than once every four years thereafter. The staff has prepared this report in connection with the first review.

The Dodd-Frank Act also required the Comptroller General of the United States to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.¹⁹ The U.S. Government Accountability Office published its report (the “GAO Report”) in July 2013.²⁰

¹⁶ JOBS Act § 201(a). The Commission revised Rule 506 in July 2013. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013) [78 FR 44771] (the “Rule 506(c) Adopting Release”).

¹⁷ Uniform Securities Act of 2002 §§ 102(11)(F) through 102(11)(K), 102(11)(O) & 202(13), National Conference of Commissioners on Uniform State Laws (also known as the Uniform Law Commission). The Uniform Law Commission provides states with model legislation in areas of state statutory law when uniformity is desired and practicable. The Uniform Securities Act of 2002 is a model state securities law.

¹⁸ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁹ Dodd-Frank Act § 415.

²⁰ U.S. Government Accountability Office, GAO-13-640, Alternative Criteria for Qualifying As An

Although regulators and market participants increasingly rely on the accredited investor definition, it has not been comprehensively re-examined since its adoption in 1982. Since that time, general inflationary effects have expanded significantly the pool of persons that qualify as accredited investors. In addition, developments such as increased informational availability, as well as changes in the way investors communicate, have altered the investing landscape. Further, financial product and process innovation over the past three decades have led to more complex financial markets while greatly expanding the set of available investment opportunities. Consequently, the financial criteria identified in 1982 may no longer serve as the most effective proxies for determining when investors do not require the protections that come from registration under the Securities Act. Altering the financial thresholds contained in the definition may not, by itself, be sufficient to adapt to the current investing environment.

D. Goals of the Accredited Investor Definition

The accredited investor definition attempts to identify those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.²¹ An overly narrow definition that limited the number of accredited investors could risk restricting businesses' access to a crucial source of capital and be inconsistent with the Commission's capital formation mandate. An overly broad definition, on the other hand, could potentially be inconsistent with the Commission's investor protection mandate and run counter to one of the

Accredited Investor Should Be Considered (July 18, 2013). The GAO Report recommended that the Commission consider alternative criteria to help determine an individual's ability to bear and understand the risks associated with investing in private placements.

²¹ See Regulation D Revisions Proposing Release.

basic tenets of the Securities Act by failing to provide investors in need of protection with adequate disclosures before they make an investment decision.

Additionally, a fundamental objective of the accredited investor definition is to create bright-line tests that allow market participants to readily determine an investor's status under the definition. The need for clarity is particularly important because an issuer relying on an exemption from registration carries the burden of proving that the exemption is available. Clarity and certainty in the accredited investor definition foster greater confidence in unregistered markets and ultimately could reduce the cost of capital, thereby promoting increased capital formation, particularly for small businesses. Indeed, Regulation D was adopted, in part, to bring a greater degree of clarity for small businesses than was present under the prior exemptive scheme.²²

E. Scope of the Report

Section 413(b)(2)(A) of the Dodd-Frank Act directs the Commission to review the accredited investor definition, in its entirety, as it applies to natural persons. In the interest of providing a comprehensive analysis of the definition, this report also addresses aspects of the definition as it applies to entities. This report provides background information on the origins of the accredited investor definition, changes to the definition since its adoption and recent Commission proposals for further amendments to the definition. It describes relevant comments

²² See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791] (the "Regulation D Proposing Release"). In the context of small business hearings held in the late 1970s, commenters indicated that small businesses had frustrations with the subjective determinations former Rule 146 required. Commenters indicated that the uncertain applicability of the rule complicated legal opinions and increased transaction costs. See Summary of Comments Relating to Small Business Hearings and Proposed Form S-18, Division of Corporation Finance, Securities and Exchange Commission, File No. S7-734.

on the definition received in prior Commission rulemakings, academic literature on the topic and recommended changes to the definition from a variety of sources. It also considers alternative approaches under federal and state securities laws for identifying types of financially sophisticated investors and considers the impact any definitional changes may have outside the context of Regulation D. Finally, this report examines alternative approaches to defining the term “accredited investor” and provides staff recommendations for updates and modifications to the existing definition.

F. Recommendations

The staff recommends that the Commission consider any one or more of the following methods of revising the accredited investor definition:

- *The Commission should revise the financial thresholds 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 new, 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.
- *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.

Section IX describes these recommendations in detail.

II. History of the Accredited Investor Definition

The Securities Act and the rules and regulations adopted thereunder define the term

“accredited investor” in the following places:

- *Securities Act Section 2(a)(15)*²³ and *Rule 215 under the Securities Act*²⁴ define accredited investor for purposes of Section 4(a)(5).²⁵ Section 4(a)(5) exempts non-public offers and sales of up to \$5 million made solely to accredited investors. The definition of accredited investor in Section 2(a)(15) enumerates certain categories of persons and authorizes the Commission to prescribe additional categories. Pursuant to this authority, the Commission has prescribed additional categories in Rule 215.²⁶
- *Rule 501(a) under the Securities Act*²⁷ defines accredited investor as that term is used

²³ 15 USC 77b(a)(15).

²⁴ 17 CFR 230.215.

²⁵ 15 USC 77d(a)(5).

²⁶ This report focuses on the accredited investor definition as used in Regulation D, with the understanding that any revisions to the definition should be made to the Rule 215 definition as well.

²⁷ 17 CFR 230.501(a).

in Regulation D.²⁸

Regulation D relates to transactions exempted from the registration requirements of Section 5²⁹ of the Securities Act under Rules 504,³⁰ 505,³¹ 506(b) and 506(c).³²

- *Rule 504* provides an exemption for the public offer and sale of up to \$1 million in a twelve-month period. General solicitation and general advertising are permitted if the offering is registered in a state requiring the use of a substantive disclosure document or sold exclusively to accredited investors under a corresponding state exemption.
- *Rule 505* provides an exemption for the offer and sale of up to \$5 million in a twelve-month period to an unlimited number of accredited investors and up to 35 additional persons.
- *Rule 506(b)* is available for sales of unlimited amounts of securities to accredited investors and up to 35 non-accredited, but sophisticated, investors. Offerings relying on Rule 506(b) cannot involve general solicitation or general advertising.
- Rule 506(c) allows issuers to use general solicitation and general advertising, provided all purchasers are accredited investors and the issuer takes reasonable steps to verify their accredited investor status. Issuers may sell unlimited amounts of securities under Rule 506(c).

The presence of non-accredited investors in Regulation D offerings has implications for the type of disclosures that issuers are required to provide. Under Rules 505 and 506(b), issuers must provide the financial and non-financial information specified in Rule 502(b)³³ to any non-

²⁸ Rules 215 and 501(a) are identical except that Rule 501(a) permits reasonable belief by an issuer and includes banks, insurance companies, investment companies, business development companies and small business investment companies in the definition and permits additional entities to be fiduciaries for benefit plans that are accredited investors. The accredited investor definition in Securities Act Section 2(a)(15) contains banks, insurance companies, investment companies, business development companies and small business investment companies and employee benefit plans with banks, insurance companies or registered investment advisers as fiduciaries.

²⁹ 15 USC 77e.

³⁰ 17 CFR 230.504.

³¹ 17 CFR 230.505.

³² 17 CFR 230.506(c).

³³ 17 CFR 230.502(b). Issuers generally must furnish investors with information comparable to that which

accredited investors.³⁴

The accredited investor definition reflects movement away from general principles and standards towards bright-line tests. This section discusses the background and history of the accredited investor definition, from the legislative history of the Securities Act through the original small business exemptions and the introduction of the term to the Securities Act, and concludes with a description of the definition under Regulation D and its subsequent amendments.

A. Securities Act Section 4(a)(2) and Judicial Precedent

The legislative history of the Securities Act indicates that Congress's main objective was to provide full and fair disclosure in connection with the offer and sale of securities. Congress recognized, however, that there were certain situations in which the protections afforded by the Securities Act were not necessary. The House report stated that “[t]he Securities Act carefully exempts from its application certain types of ... securities transactions where there is no practical need for its application or where the public benefits are too remote.”³⁵

Securities Act Section 4(a)(2),³⁶ an exemption from the registration requirements of Section 5 of the Securities Act, provides that “the provisions of Section 5 shall not apply to ... transactions by an issuer not involving any public offering.” The Securities Act does not define the phrase “transactions ... not involving any public offering.” Accordingly, it has been left to

would be included in a registration statement for a registered offering.

³⁴ The note to Rule 502(b)(1) states that when an issuer provides information to non-accredited investors it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.

³⁵ H.R. Rep. No. 73-85 (1933).

³⁶ 15 USC 77d(a)(2).

court decisions and Commission interpretations to define the scope of the exemption.

In *S.E.C. v. Ralston Purina Co.*,³⁷ the Supreme Court established the basic criteria for determining the availability of Section 4(a)(2). The Court held that the availability of Section 4(a)(2) should turn on whether the particular class of persons affected need the protection afforded by the Securities Act. The Court found that an offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering. The Court further observed that offerings to persons who have access to the same kind of information that the Securities Act would make available in the form of a registration statement may come within the exemption.

Section 4(a)(2) was traditionally viewed as a way to provide “an exemption from registration for bank loans, private placements of securities with institutions, and the promotion of a business venture by a few closely related persons.”³⁸ In 1962, prompted by increased use of the exemption for speculative offerings to unrelated and uninformed persons, the Commission clarified limitations on the exemption’s availability.³⁹ The Commission stated that “[w]hether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.”⁴⁰

³⁷ 346 U.S. 119 (1953).

³⁸ *See* Non-Public Offering Exemption, Release No. 33-4552 (Nov. 6, 1962) [27 FR 11316].

³⁹ *Id.*

⁴⁰ The Commission also noted that public advertising would be incompatible with a claim of a private offering. *Id.*

B. Small Business Exemptions Prior to Regulation D

Securities Act Rule 146

The Commission adopted Rule 146 in 1974 in an effort to provide greater certainty in the application of the Section 4(a)(2) exemption.⁴¹ The rule was available to all issuers and could be used to raise an unlimited amount of capital. Use of Rule 146 was conditioned on the following:

- Offers and sales could be made only to persons the issuer reasonably believed had the requisite knowledge and experience in financial matters to evaluate the risks and merits of the prospective investment or who could bear the economic risks of the investment.
- Sales could not be made to persons who did not have the requisite knowledge and experience in financial matters unless they had a representative who was capable of providing the requisite financial knowledge and experience.
- Offerees must have had access to, or been furnished with, information comparable to what a registration statement would contain.
- No more than 35 purchasers could participate in an offering.
- General advertising and general solicitation were not permitted.

In the adopting release, the Commission identified two goals for Rule 146. First, the rule would deter reliance on the Section 4(a)(2) exemption for offerings to persons who were unable to fend for themselves in terms of obtaining and evaluating information about the issuer and, in certain situations, of assuming the economic risk of investment. Second, the rule would reduce uncertainty and provide more objective standards upon which to rely when raising capital.

⁴¹ See Transactions By an Issuer Deemed Not To Involve Any Public Offering, Release No. 33-5487 (Apr. 23, 1974) [39 FR 15261]. If all the conditions of Rule 146 were met, the offer and sale of securities were deemed to not involve any public offering within the meaning of Section 4(a)(2). The Commission rescinded Rule 146 in 1982 in connection with the adoption of Regulation D.

Securities Act Rule 240

In 1975, the Commission adopted Rule 240⁴² for the purpose of benefiting small businesses that did not have other exemptions available to them.⁴³ Rule 240 required issuers to have no more than 100 beneficial owners both before and after the offering, limited the aggregate amount of securities sold in a twelve-month period to \$100,000 and prohibited general advertising and general solicitation.

Securities Act Rule 242

Despite the adoption of Rules 146 and 240, the uncertainty surrounding private placements and small business offerings continued. Beginning in 1978, the Commission conducted an extensive evaluation, including public hearings,⁴⁴ into the impact of its rules and regulations on the ability of small businesses to raise capital.⁴⁵ Primarily as a result of the views expressed at the hearings, the Commission took several significant actions designed to ease the impact of the federal securities laws on small businesses consistent with the protection of investors, including adopting Rule 242.⁴⁶ Rule 242 provided a limited offering exemption under

⁴² See Exemption For Closely Held Issuers, Release No. 33-5560 (Jan. 24, 1975) [40 FR 6484]. The Commission rescinded Rule 240 in 1982 in connection with the adoption of Regulation D.

⁴³ See Examination of the Effects of Rules and Regulations on the Ability of Small Businesses to Raise Capital and the Impact on Small Businesses of Disclosure Requirements Under the Securities Acts; Release No. 33-5914 (Mar. 6, 1978) [43 FR 10876] (the “Small Business Study Release”).

⁴⁴ During April and May of 1978, the Commission held 21 days of public hearings in six cities across the country.

⁴⁵ See Small Business Study Release.

⁴⁶ See Exemption of Limited Offers and Sales by Qualified Issuers, Release No. 33-6180 (Jan. 17, 1980) [45 FR 6362]. The Commission rescinded Rule 242 in 1982 in connection with the adoption of Regulation D. Other actions included amending Regulation A to increase the aggregate offering amount of securities that could be sold thereunder during a twelve month period from \$500,000 to \$1.5 million and amending Rule 146 to relax the disclosure requirements for offerings not in excess of \$1.5 million. See also Simplified Registration and Reporting Requirements for Small Issuers, Release No. 33-6049 (Apr. 3, 1979) [44 FR

Section 3(b)(1) of the Securities Act⁴⁷ for offerings up to \$2 million. It also introduced the accredited investor concept into the federal securities laws. Rule 242 allowed certain domestic and Canadian corporate issuers to sell their securities to an unlimited number of accredited persons and up to 35 non-accredited persons. Rule 242 did not require issuers to make any subjective determination about the sophistication or financial condition of offerees and purchasers. Rather, issuers were required to determine only whether potential investors were accredited or non-accredited persons based on the objective criteria set forth in the rule. Rule 242 defined “accredited person” as a person purchasing \$100,000 or more of the issuer’s securities, a director or executive officer of the issuer or a specified type of entity.⁴⁸ If only accredited persons were involved in an offering, there was no specific requirement to furnish them with information, based on the assumption that accredited persons were in a position to ask for and obtain the information they believed was relevant to an offering.⁴⁹ Like Rule 146, Rule 242 prohibited general advertising and general solicitation.

C. The Small Business Investment Incentive Act of 1980

Congress responded to the need to reform the federal securities laws to facilitate small business access to the capital markets by enacting the Small Business Investment Incentive Act

21562].

⁴⁷ 15 USC 77c(b)(1).

⁴⁸ Specified entities were banks (whether acting in their individual or fiduciary capacities), insurance companies, employee benefit plans (with investment decisions made by plan fiduciaries), investment companies, and licensed Small Business Investment Companies.

⁴⁹ *See* Consideration of the Impact of the Small Business Investment Incentive Act of 1980 on Certain Exemptions From the Registration Provisions of the Securities Act of 1933, Release No. 33-6274 (Dec. 23, 1980) [46 FR 2631] (the “Small Business Investment Incentive Act Impact Release”).

of 1980 (the “Incentive Act”).⁵⁰ The Incentive Act exempted from Securities Act registration non-public offers and sales of up to \$5 million made solely to accredited investors⁵¹ and added the accredited investor definition to Section 2(a)(15) of the Securities Act.

Section 2(a)(15)(i)⁵² defined accredited investor to mean certain enumerated entities⁵³ and Section 2(a)(15)(ii)⁵⁴ authorized the Commission to adopt additional categories based on “such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management.” The Commission has used this authority to expand the types of persons that qualify as accredited investors.⁵⁵ The Incentive Act also increased the ceiling on the Commission’s authority to create small offering exemptions from \$2 million to \$5 million⁵⁶ and authorized the Commission to work with the states to develop a uniform exemption from registration for small issuers.⁵⁷

D. Regulation D

Prompted by the enactment of the Incentive Act, on December 23, 1980, the Commission published an advance notice of rulemaking and announced that it was considering the

⁵⁰ Pub. L. No. 96-477, 94 Stat. 2275 (1980).

⁵¹ Securities Act § 4(a)(5).

⁵² 15 USC 77b(a)(15)(i).

⁵³ Banks (whether acting in their individual or fiduciary capacities), insurance companies, registered investment companies, business development companies, licensed Small Business Investment Companies, and employee benefit plans (with investment decisions made by plan fiduciaries).

⁵⁴ 15 USC 77b(a)(15)(ii).

⁵⁵ For example, in 1988 the Commission expanded the definition to include corporations, among other entities. *See* Regulation D Revisions, Release No. 33-6758 (Mar. 3, 1988) [53 FR 7866] (the “Regulation D Revisions Adopting Release”).

⁵⁶ Securities Act § 3(b)(1).

⁵⁷ Securities Act § 19(d)(3).

relationship between the Securities Act exemptions from registration and the capital formation needs of small businesses.⁵⁸ The Commission asked commenters to focus on the interrelationship between the statutory exemption from registration for sales to accredited investors created by the Incentive Act and the Commission's other exemptive rules, especially Rules 146 and 242.

Regulation D was the product of the Commission's evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital.⁵⁹ Promulgated in 1982, Regulation D was a series of six rules that established two exemptions and one non-exclusive safe harbor from the registration requirements of the Securities Act and replaced the exemptions existing under Rules 146, 240 and 242. Rule 506 replaced Rule 146 and provided a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act. Rules 504 and 505 replaced Rules 240 and 242, respectively, and provided exemptions to registration under Section 3(b)(1) of the Securities Act.

The Commission designed Regulation D to simplify existing rules and regulations, particularly for small businesses, and achieve uniformity between state and federal exemptions to facilitate capital formation consistent with the protection of investors. A significant achievement in the adoption of Regulation D was the unification of much of the Commission's exemptive scheme into a single regulation with common definitions, terms and conditions.⁶⁰

⁵⁸ Small Business Investment Incentive Act Impact Release.

⁵⁹ Regulation D Adopting Release.

⁶⁰ See Manning Gilbert Warren, III, *A Review of Regulation D: The Present Exemption Regimen For Limited Offerings Under The Securities Act of 1933*, 33 AM. U. L. Rev. 355 (1984).

The accredited investor definition is a cornerstone of Regulation D.⁶¹ Rule 501 defines the term by listing eight categories of persons and entities that qualify as accredited investors. As originally constructed, certain institutional investors, private business development companies, charitable organizations, company insiders, purchasers of more than \$150,000, natural persons with substantial net worth or income and entities, all of whose equity owners were accredited, qualified as accredited investors. The concept intended to encompass those persons and entities whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.⁶²

The accredited investor definition originally included persons who purchased at least \$150,000 of the securities being offered where the total purchase price did not exceed twenty percent of the person's net worth. The premise behind the \$150,000 minimum purchase requirement was that individuals capable of investing large amounts of capital in an offering should be considered accredited investors because of their bargaining power.⁶³ The Commission

⁶¹ See Regulation D Proposing Release; Regulation D Adopting Release. Like its predecessor, Rule 242, the principal requirements of Regulation D depend upon whether or not an investor is accredited. An issuer need not make a determination about an accredited investor's sophistication, although an issuer is required to make a determination about a non-accredited investor's sophistication under Rule 506(b). Issuers may sell to an unlimited number of accredited investors under Rules 505 and 506(b), but may sell to no more than 35 non-accredited investors. Under Rules 505 or 506(b), issuers have no disclosure delivery requirement if sales are exclusively to accredited investors. Regulation D relies upon the same assumption employed by Rule 242 that accredited investors are in a position to ask for and obtain the information they believe is relevant. Only if an issuer sells to a non-accredited investor do Rules 505 and 506(b) require delivery of a specified disclosure document. Disclosures are required to the extent material to an understanding of the issuer, its business and the securities being offered.

⁶² See Regulation D Adopting Release; Regulation D Revisions Proposing Release; Regulation D Revisions Adopting Release.

⁶³ See Regulation D Proposing Release; Regulation D Adopting Release.

rescinded this provision in 1988⁶⁴ because of an anomaly with the \$1 million net worth test and concerns that purchase size alone, particularly at the \$150,000 level, did not assure sophistication or access to information.⁶⁵

Like Rule 242, the accredited investor definition includes an issuer's directors and executive officers, but unlike Rule 242, also includes the general partners of an issuer and the directors, executive officers, and general partners of a general partner of the issuer. These insiders are deemed not to need the protections provided by registration because their positions should provide them with access to information about the issuer and the securities offered.⁶⁶

Income and Net Worth Tests

Regulation D established bright-line tests for individuals to qualify as accredited investors based on their income or net worth. The income and net worth tests, respectively, currently read as follows:

- Any natural person who had individual 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 has a reasonable expectation of reaching the same income level in the current year.⁶⁷
- Any natural person whose individual net worth, or joint net worth with that person's

⁶⁴ Regulation D Revisions Adopting Release.

⁶⁵ The provision permitted a natural person with as little as \$750,000 of net worth to be considered accredited with a \$150,000 purchase while a \$1 million net worth was required to accredit a natural person for a smaller purchase. *See* Regulation D Revisions Proposing Release.

⁶⁶ After soliciting public comment, the Commission decided not to accredit sophisticated officers who are not executive officers because it was not persuaded that, absent a policy-making function characterizing an executive officer position, other officers and employees would have sufficient access to information and the ability to bear the risk necessary to achieve the status of accredited investor. *See* Regulation D Revisions Adopting Release.

⁶⁷ 17 CFR 230.501(a)(6). The test is designed to exclude persons who have nonrecurring income spikes for one or two years.

spouse, exceeds \$1 million.⁶⁸

Other than expanding the income test to include a joint income component⁶⁹ and excluding the value of one's primary residence from the net worth calculation,⁷⁰ the Commission has not revised the income and net worth tests since 1982.

2006 Accredited Natural Person Proposal

In 2006, the Commission proposed, but ultimately never adopted, rules under the Securities Act that would have created a new category of accredited investor called an "accredited natural person."⁷¹ The new category would have been applicable only to offers and sales of securities issued by companies relying on Section 3(c)(1) of the Investment Company Act of 1940 (the "Investment Company Act").⁷² "Accredited natural person" would have been defined as any natural person who met the Regulation D net worth or income tests and owned at least \$2.5 million in investments. The term "investments" would have been defined based on the definition used in Investment Company Act Rule 2a51-1(b).⁷³

2007 Proposal to Amend the Accredited Investor Definition

In 2007, the Commission proposed, but ultimately never adopted, significant revisions to

⁶⁸ 17 CFR 230.501(a)(5).

⁶⁹ See Regulation D Revisions Adopting Release.

⁷⁰ See Net Worth Standard for Accredited Investors, Release No. 33-9287 (Dec. 21, 2011) [76 FR 81793] (the "Primary Residence Adopting Release"). Section 413(a) of the Dodd-Frank Act directed the Commission to adjust the net worth calculation by excluding the value of a person's primary residence.

⁷¹ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. 33-8766 (Dec. 27, 2006) [72 FR 400] (the "Private Pooled Investment Vehicle Release").

⁷² 15 USC 80a-3(c)(1).

⁷³ 17 CFR 270.2a51-1(b).

the accredited investor definition as it applies to natural persons to:⁷⁴

- add an alternative “investments-owned” test of \$750,000 that could be used instead of the net worth or income tests;⁷⁵
- define a new term, “joint investments,” that would include only 50% of any investment held jointly with a spouse unless both spouses sign and are bound by the investment documentation;⁷⁶ and
- establish an inflation adjustment for all dollar-amount thresholds on a going-forward basis with adjustments every five years to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, rounded to the nearest multiple of \$10,000.

Exclusion of Primary Residence from Net Worth Calculation

Section 413(a) of the Dodd-Frank Act excluded the value of a person’s primary residence from the net worth calculation and directed the Commission to adjust similarly any accredited investor net worth standard in its Securities Act rules. In 2011, the Commission revised Rules 215 and 501 to exclude any positive equity individuals have in their primary residences.⁷⁷ The revised calculation requires that any excess of indebtedness secured by the primary residence over the estimated fair market value of the residence be considered a liability for purposes of determining accredited investor status on the basis of net worth. The Commission also added a 60-day look-back period to prevent investors from artificially inflating their net worth by

⁷⁴ See Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116] (the “2007 Proposing Release”).

⁷⁵ The proposed definition of “investments” was based on Rule 2a51-1 of the Investment Company Act of 1940, which defines “investments” for purposes of defining “qualified purchaser” in Section 2(a)(51)(A) of the Investment Company Act.

⁷⁶ In contrast, the current accredited investor definition includes all assets an individual owns jointly with a spouse or that are part of a shared community interest in the net worth calculation.

⁷⁷ See Primary Residence Adopting Release.

incurring incremental indebtedness secured by their primary residence, thereby effectively converting their home equity into cash or other assets that would be included in the net worth calculation.

Rule 506(c) of Regulation D

Section 201(a) of the JOBS Act directed the Commission to eliminate the prohibition against general solicitation and general advertising under Rule 506 where all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. To implement Section 201(a), the Commission added paragraph (c) to Rule 506.⁷⁸ Under Rule 506(c), an issuer may offer securities using general solicitation and general advertising, provided that:

- all purchasers in the offering are accredited investors;
- the issuer takes reasonable steps to verify the purchasers' accredited investor status; and
- certain other conditions in Regulation D are satisfied.

The determination of the reasonableness of the steps taken to verify accredited investor status is an objective assessment. Issuers are required to consider the facts and circumstances of each purchaser and the transaction. The final rule also provides a non-exclusive list of methods that issuers may use to satisfy the verification requirement.

III. Other Regulatory Approaches

The federal securities laws and other regulatory regimes use a number of distinct standards, including the accredited investor definition, to identify persons who are not in need of certain investor protection features contained in those laws and regimes. While other standards

⁷⁸ See Rule 506(c) Adopting Release.

may provide useful context for considering the accredited investor definition, each serves a different specific regulatory purpose. Table 3.1 compares the different standards for natural persons, their corresponding financial thresholds and regulatory purposes.

Table 3.1 Comparison of Regulatory Standards

| Standard | Financial Threshold for Natural Persons | Regulatory Purpose |
|--|--|---|
| Accredited Investor (Securities Act Rule 501(a)) | \$200,000 in income \$300,000 in joint income \$1 million in net worth, excluding the value of a primary residence | Exemption from Securities Act registration for offers and sales to accredited investors |
| Qualified Client (Advisers Act Rule 205-3) | \$1 million in assets under management with an investment adviser \$2 million in net worth, excluding the value of a primary residence Subject to inflation adjustment every 5 years | Exemption from Advisers Act's prohibition on charging performance fees to clients |
| Qualified Purchaser (Investment Company Act Section 2(a)(51)(A)) | \$5 million in investments | Exemption from Investment Company Act registration for sales to qualified purchasers |
| Qualified Investor (Exchange Act Section 3(a)(54)) | \$10 million in asset-backed securities and loan participations \$25 million in other investments | Exemption from broker-dealer registration for banks that sell certain securities to qualified investors |
| Eligible Contract Participant (Commodity Exchange Act Section 1a(18)) | \$10 million in investments \$5 million in investments if hedging | Eligible contract participants are able to engage in certain derivatives and swaps transactions |

This section provides more detailed descriptions of the standards in the above table as well as other approaches to identifying individuals who do not need certain investor protections. Many of the standards described in this section use thresholds based on the amount of an individual’s investments. In contrast, the accredited investor definition uses income and net worth.

A. Qualified Client

The Investment Advisers Act of 1940 (the “Advisers Act”) generally prohibits investment advisers from charging performance fees to clients.⁷⁹ Rule 205-3⁸⁰ under the Advisers Act provides a limited exemption from that prohibition when a client meets the definition of “qualified client.” A “qualified client” is a natural person who, or a company that:

- has at least \$1 million in assets under management with the adviser immediately after entering into an investment advisory contract with the adviser;
- the adviser reasonably believes has a net worth (together with assets held jointly with a spouse) of more than \$2 million immediately prior to entering into an advisory contract;
- the adviser reasonably believes is a “qualified purchaser” as defined in Section 2(a)(51)(A) of the Investment Company Act⁸¹ at the time an advisory contract is entered into;
- is an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the adviser; or
- is an employee of the adviser who participates in the investment activities of the

⁷⁹ Section 205(a)(1) of the Advisers Act (15 USC 80b-5(a)(1)) restricts an investment adviser from entering into, extending, renewing or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client.

⁸⁰ 17 CFR 275.205-3.

⁸¹ 15 USC 80a-2(a)(51)(A).

adviser, and has performed investment activities for at least twelve months. By providing relief from the Advisers Act's general prohibition against linking adviser compensation to gains or appreciation of assets under management, Rule 205-3 recognizes that some clients are financially experienced and able to bear the risks of performance fee arrangements.⁸² In adopting Rule 205-3, the Commission explained that it is consistent with investor protection and the purpose of the Advisers Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate.

When proposing the qualified client definition, the Commission noted that an objective financial means test would ensure that clients entering into performance fee contracts could bear the risks associated with performance fees.⁸³ The Commission has adjusted this test over time. In 1998, the Commission adopted a rule that increased the assets-under management test from \$500,000 to \$750,000, and the net worth test from \$1 million to \$1.5 million.⁸⁴ These changes adjusted for the effects of inflation since 1985. More recently, Section 418 of the Dodd-Frank Act required the Commission to adjust the thresholds for inflation between 1998 and 2010 and every five years thereafter. In 2011, the Commission issued an order that increased the threshold

⁸² See Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-996 (Nov. 14, 1985) [50 FR 48556].

⁸³ See Conditional Exemption To Allow Registered Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-961 (Mar. 15, 1985) [50 FR 11718].

⁸⁴ See Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-1731 (July 15, 1998) [63 FR 39022].

amounts for both tests to their current levels⁸⁵ and in 2012 revised Rule 205-3 to provide for inflation adjustments every five years.⁸⁶ In tandem, the Commission also amended the rule to exclude the value of a person's primary residence from the test of whether a person meets the net worth requirement. The Commission noted that excluding the primary residence was similar to the approach in the most recent amendments to the accredited investor definition and was responsive to commenters who urged the Commission to promote regulatory consistency in the treatment of primary residences.

B. Qualified Purchaser Under the Investment Company Act

Congress determined that the amount of a person's investments should be used to measure a person's financial sophistication for purposes of the Investment Company Act when it enacted the National Securities Markets Improvement Act of 1996 ("NSMIA").⁸⁷ NSMIA created a new exception from the definition of "investment company" for issuers that sell their securities solely to qualified purchasers.⁸⁸ The term qualified purchaser means:

- natural persons who own not less than \$5 million in investments;
- family-owned companies that own not less than \$5 million in investments;
- certain trusts; and

⁸⁵ See Order Approving Adjustments for Inflation of the Dollar Amount Tests in Rule 205-3 Under the Investment Advisers Act of 1940, Release No. IA-3236 (July 12, 2011) [76 FR 41838].

⁸⁶ See Investment Adviser Performance Compensation, Release No. IA-3372 (Feb. 15, 2012) [77 FR 10358]. This release added Rule 205-3(e), which provides for inflation adjustments every five years based on the Personal Consumption Expenditures Chain-Type Price Index (or any successor thereto) as published by the United States Department of Commerce (the "PCE"). This release also codified the inflation-adjusted amounts set in the 2011 order.

⁸⁷ Pub. L. No. 104-290, 110 Stat. 3416 (1996).

⁸⁸ NSMIA § 209(a); Investment Company Act § 3(c)(7)(A).

- persons, acting for their own accounts or the accounts of other qualified purchasers, who in the aggregate own and invest on a discretionary basis, not less than \$25 million in investments (*e.g.*, institutional investors).⁸⁹

The legislative history of NSMIA indicates that reliance on the exemption under Section 3(c)(7) of the Investment Company Act⁹⁰ was to be limited to private investment companies consisting solely of investors with a high degree of financial sophistication who are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the Investment Company Act.⁹¹ The legislative history suggests that Congress viewed these investors as capable of evaluating on their own behalf matters such as a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption rights.

Congress tasked the Commission with defining the term “investments” for purposes of the qualified purchaser definition⁹² and the Commission adopted a broad definition.⁹³ Investment Company Act Rule 2a51-1(b)⁹⁴ defines “investments” to include securities (other than controlling interests in certain issuers), real estate held for investment purposes, commodity

⁸⁹ NSMIA § 209(b); Investment Company Act § 2(a)(51)(A).

⁹⁰ 15 USC 80a-3(c)(7).

⁹¹ *See* S. Rep. No. 104-293 (1996). *See also* Private Investment Companies, Release No. IC-22405 (Dec. 18, 1996) [61 FR 68100].

⁹² NSMIA § 209(d)(2).

⁹³ *See* Privately Offered Investment Companies, Release No. IC-22597 (Apr. 3, 1997) [62 FR 17512] (the “Privately Offered Investment Companies Adopting Release”). The Commission indicated that NSMIA’s legislative history suggests that Congress intended for the “investments” definition to be broader than securities, but that not every type of asset should be included. The Commission also indicated that the legislative history suggests that an asset included in the definition should be held for investment purposes and the nature of the asset should indicate that its holder has the investment experience and sophistication necessary to evaluate the risks of investing in unregulated investment pools.

⁹⁴ 17 CFR 270.2a51-1(b).

interests held for investment purposes, physical commodities held for investment purposes, financial contracts entered into for investment purposes and cash and cash equivalents held for investment purposes.

NSMIA also directed the Commission to prescribe rules permitting knowledgeable employees of a private fund (or knowledgeable employees of the fund’s affiliates) to invest in the fund without causing the fund to lose its exemption from registration under the Investment Company Act.⁹⁵ This provision permits individuals who participate in a fund’s management to invest in the fund as a benefit of employment.

C. Qualified Purchaser Under the Securities Act

NSMIA realigned the federal and state regulatory partnership governing securities regulation. The legislative history of NSMIA indicates that Congress intended to preempt state registration of certain offers and sales of securities for the purpose of providing uniform, nationwide exemptions from registration and qualification requirements at the state level.⁹⁶

Among other changes, NSMIA added Section 18(b)(3) to the Securities Act,⁹⁷ which provides an exemption from state securities registration and qualification requirements for securities offerings and sales to “qualified purchasers.”⁹⁸ Section 18(b)(3) of the Securities Act further provides that “the Commission may define the term ‘qualified purchaser’ differently with respect to different categories of securities, consistent with the public interest and the protection

⁹⁵ NSMIA § 209(d)(3).

⁹⁶ See H.R. Rep. No. 104-622 (1996). See also Defining the Term “Qualified Purchaser” Under the Securities Act of 1933, Release No. 33-8041 (Dec. 19, 2001) [66 FR 66839] (the “Qualified Purchaser Proposing Release”).

⁹⁷ 15 USC 77r(b)(3).

⁹⁸ NSMIA § 102(a).

of investors.”

In 2001, the Commission proposed to define the term “qualified purchaser” to mean an “accredited investor,” as defined in Rule 501(a) of Regulation D, for purposes of Section 18(b)(3).⁹⁹ The proposed definition was not limited to any particular type or class of security, or transaction in such security. Rather, the Commission explained that the proposed definition identified well-established categories of persons it previously determined to be financially sophisticated and therefore not in need of the protection of state registration. The Commission did not, however, adopt a qualified purchaser definition.

Title IV of the JOBS Act added Section 3(b)(2) to the Securities Act,¹⁰⁰ which directed the Commission to adopt a new exemption from registration for securities offerings of up to \$50 million in a twelve-month period.¹⁰¹ Additionally, Title IV added Section 18(b)(4)(D)(ii) to the Securities Act,¹⁰² which provides that Section 3(b)(2) securities are covered securities for purposes of Section 18 if they are “offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale.”

In March 2015, the Commission adopted rules to implement Title IV of the JOBS Act by amending Regulation A¹⁰³ to create two tiers of exempt offerings:

- Tier 1 for offerings of up to \$20 million in a twelve-month period, including no more than \$6 million offered on behalf of selling securityholders that are affiliates of the issuer; and

⁹⁹ See Qualified Purchaser Proposing Release.

¹⁰⁰ 15 USC 77c(b)(2).

¹⁰¹ JOBS Act § 401(a).

¹⁰² 15 USC 77r(b)(4)(D)(ii).

¹⁰³ Regulation A – Conditional Small Issues Exemption, 17 CFR 230.251 through 263.

- Tier 2 for offerings of up to \$50 million in a twelve-month period, including no more than \$15 million offered on behalf of selling securityholders that are affiliates of the issuer.¹⁰⁴

All purchasers in a Tier 2 offering must be either accredited investors or persons who limit their investment amounts to no more than 10% of the greater of their annual income or their net worth.¹⁰⁵ Consistent with the authority provided in Sections 18(b)(3) and 18(b)(4)(D) of the Securities Act, and in light of the total package of investor protections included in amended Regulation A,¹⁰⁶ the Commission defined the term “qualified purchaser” for purposes of Regulation A offerings to mean any person to whom securities are offered or sold in a Tier 2 offering.¹⁰⁷

D. Qualified Institutional Buyer

In 1990, the Commission defined “qualified institutional buyer” (“QIB”), another category of financially sophisticated investors as part of Rule 144A¹⁰⁸ under the Securities Act.¹⁰⁹ Rule 144A provides a safe harbor exemption from the registration requirements of the federal securities laws for resales of restricted securities to QIBs. The term “qualified institutional

¹⁰⁴ Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Release No. 33-9741 (Mar. 25, 2015) 80 FR 21806 (the “Regulation A+ Adopting Release”).

¹⁰⁵ For non-natural persons, the investment limitation is 10% of the greater of annual revenues or net assets at fiscal year end. The investment limitation does not apply to investments in securities that will be listed on a national securities exchange upon qualification.

¹⁰⁶ In addition to investment limitations, Tier 2 offerings include a substantive disclosure document, including audited financial statements, that must be reviewed and qualified by Commission staff, bad actor disqualification provisions and ongoing reporting obligations.

¹⁰⁷ 17 CFR 230.256.

¹⁰⁸ 17 CFR 230.144A.

¹⁰⁹ *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Release No. 33-6862 (Apr. 23, 1990) [55 FR 17933].

buyer” includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least \$100 million in securities of non-affiliated issuers. Banks and other specified financial institutions must also have a net worth of at least \$25 million. A registered broker-dealer qualifies as a QIB if, in the aggregate, it owns and invests on a discretionary basis at least \$10 million in securities of issuers that are not affiliated with the broker-dealer.

E. Qualified Investor

The Gramm-Leach-Bliley Act¹¹⁰ added the term “qualified investor” to the Securities Exchange Act of 1934 (the “Exchange Act”) for purposes of exemptions for banks from broker-dealer registration.¹¹¹ The exemptions permit banks to sell certain securities to qualified investors without registering as broker-dealers with the Commission. Exchange Act Section 3(a)(54)¹¹² defines “qualified investor” to include a list of persons, some of which meet the definition by merely being certain types of entities, while others must also meet an ownership and investment test. For example, registered investment companies and banks are qualified investors without having to meet an ownership and investment test; natural persons, corporations, companies and partnerships are qualified investors if they own and invest, on a discretionary basis, not less than \$25 million in investments;¹¹³ and governments and political subdivisions are qualified investors if they own and invest, on a discretionary basis, not less than \$50 million in investments.

The entities that are qualified investors without limitation based on ownership and

¹¹⁰ Pub. L. No. 106-102, 113 Stat. 1338 (1999).

¹¹¹ Exchange Act §§ 3(a)(4)(B)(ix), 3(a)(5)(C)(iii), 3(a)(5)(C)(iv) & 3(a)(54).

¹¹² 15 USC 78c(a)(54).

¹¹³ The threshold is \$10 million for investments in asset-backed securities and loan participations.

investment are engaged primarily in financial activities, including the business of investing. In contrast, the persons subject to the ownership and investment requirement may have limited investment experience. The Commission has indicated that Congress established ownership and investment thresholds for those persons as indicators of investment experience and sophistication.¹¹⁴

F. Eligible Contract Participant

The Exchange Act and the Commodity Exchange Act define certain persons as “eligible contract participants” including based on their status as regulated entities or the amount of assets they hold or invest.¹¹⁵ Eligible contract participants can engage in derivatives and swaps transactions in which non-eligible contract participants generally are more restricted.

Individuals with more than \$10 million invested on a discretionary basis (more than \$5 million if they are hedging) are eligible contract participants.¹¹⁶ The eligible contract participant definition also includes financial institutions, insurance companies, investment companies, commodity pools with more than \$5 million in assets under management, employee benefit plans with more than \$5 million in assets, corporations and other entities with more than \$10 million in assets, corporations and other entities with at least \$1 million of net worth if they are hedging commercial risk, governmental entities with at least \$50 million in investments, registered brokers or dealers, regulated futures commission merchants and regulated floor brokers or floor

¹¹⁴ See Exemption of Certain Foreign Brokers or Dealers, Release No. 34-58047 (June 27, 2008) [73 FR 39182].

¹¹⁵ See Exchange Act § 3(a)(65) and Commodity Exchange Act § 1a(18). The Exchange Act defines “eligible contract participant” by referring to the definition in the Commodity Exchange Act.

¹¹⁶ The standard for individuals was previously based on total assets. The Dodd-Frank Act replaced the total asset standard with an amounts invested on a discretionary basis standard. Dodd-Frank Act § 721(a)(9).

traders.

G. Uniform Securities Act of 2002

The Uniform Securities Act of 2002 is a model state securities law drafted by the National Conference of Commissioners on Uniform State Laws.¹¹⁷ It does not contain a specific exemption for offers and sales to “accredited” or otherwise “sophisticated” natural persons.¹¹⁸ For entities, however, the Uniform Securities Act of 2002 exempts offers and sales to “institutional investors.”¹¹⁹ The “institutional investor” definition generally parallels the “accredited investor” definition in Securities Act Rule 501(a), but with \$10 million asset thresholds rather than \$5 million asset thresholds.¹²⁰ The drafters noted that the Uniform Securities Act of 2002 uses higher thresholds due to “the significant period of time since Rule 501(a) was adopted.”¹²¹

H. Franchise Laws

Franchise investment laws generally require franchisors to provide potential franchisees with detailed information about the business and investment.¹²² The Federal Trade Commission

¹¹⁷ According to the National Conference of Commissioners on Uniform State Laws, the Uniform Securities Act of 2002 has been adopted in Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, U.S. Virgin Islands, Vermont and Wisconsin.

¹¹⁸ Section 203 of the Uniform Securities Act of 2002, however, provides flexibility for state securities administrators to adopt exemptions in addition to those provided. For example, state securities administrators can adopt the Uniform Limited Offering Exemption or a Regulation D exemption to cover natural persons.

¹¹⁹ Uniform Securities Act of 2002 § 202(13)(A).

¹²⁰ Uniform Securities Act of 2002 § 102(11).

¹²¹ Uniform Securities Act of 2002 Official Comment No. 13.

¹²² A franchise enables someone to operate a business under a format or system developed by someone else. For example, a franchisee may purchase the right to use a franchisor’s name for a specific number of years

(the “FTC”) administers franchise regulations at the federal level and some states have additional laws governing the offer and sale of franchises. Like the federal securities laws, many franchise regulatory regimes exempt from their disclosure requirements offerings made to sophisticated prospective franchise investors. For example, FTC rules contain the following exemptions for sophisticated investors:

- The “large franchise investment” exemption for initial investments of at least \$1,084,900, exclusive of unimproved land and franchisor financing.
- The “large franchisee” exemption for franchisees that have been in business at least five years and have at least \$5,424,500 in net worth.
- The “insiders” exemption for franchise sales to the owners, directors and managers of the franchisor.¹²³

The FTC must update the financial thresholds in the exemptions every four years for inflation.¹²⁴

Some states also require registration of franchise offers and sales. Model franchise rules of the North American Securities Administrators Association (“NASAA”) contain “sophisticated purchaser exemptions” from registration for large investments and for offers and sales to existing franchisees, franchisor insiders and “sophisticated franchisees.”¹²⁵ A sophisticated franchisee is:

- a person whose net worth, or joint net worth with that person’s spouse, exceeds \$3 million at the time of purchase of the franchise, excluding the value of that person’s

and receive assistance launching and operating a business. *See* Federal Trade Commission, *A Consumer’s Guide to Buying a Franchise* (June 2015).

¹²³ 16 CFR §§ 436.8(a)(5)(i)-(ii) & (6). *See also* Disclosure Requirements and Prohibitions Concerning Franchising & Disclosure Requirements Concerning Business Opportunities (Mar. 30, 2007) [72 FR 15444] (referring to the three exemptions, collectively, as the “sophisticated investor exemptions”).

¹²⁴ 16 CFR § 436.8(b) requires inflation adjustments based on the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics (the “CPI”). The FTC last updated the thresholds in June 2012. *See* Disclosure Requirements and Prohibitions Concerning Franchising (June 18, 2012) [77 FR 36149].

¹²⁵ NASAA Model Franchise Exemptions § 3(c) (Sept. 9, 2012). The model rules parenthetically refer to “sophisticated franchisees” as “accredited investors.”

personal residence, any and all retirement or pension plan accounts or benefits, home furnishings and automobiles (a “high net worth individual”);

- a person whose gross income exceeds \$500,000 per year in each of the two most recent years, or whose joint gross income with that person’s spouse exceeds \$750,000 per year in each of those years, and who reasonably expects to reach the same income level in the year following the purchase of the franchise (a “high income individual”);
- an entity with shareholders’, members’ or partners’ equity exceeding \$5 million and which has been in business not less than five years;
- a trust with total assets exceeding \$5 million and which has been in operation not less than five years; or
- an entity or trust in which all of the equity owners are high net worth individuals or high income individuals.

While the financial criteria used in franchise investment laws provides insight into regulatory approaches to determining investor sophistication, there are distinguishing factors to consider. For example, some states have varying financial thresholds applicable to prospective franchisees beyond the federal FTC thresholds that may reflect specific investor characteristics and economic conditions in the states. In contrast, the accredited investor definition applies on a national level. Another distinguishing factor is that many franchisees take an active role in management or act as owner-operators of the franchises. As a result, their investments may represent higher percentages of their net worth.

I. International Approaches

Many foreign jurisdictions provide exemptions from registration or disclosure requirements for offers and sales of securities to sophisticated or accredited investors. These jurisdictions use a variety of methods to identify sophisticated or accredited investors.

Criteria Based on Income and Net Worth

Table 3.2 provides examples of other regulatory regimes that use the concept of measuring sophistication through income or net worth.

Table 3.2 International Income/Net Worth Approaches

| Jurisdiction | Income | U.S.\$ Equivalent* | Net Worth | U.S.\$ Equivalent* |
|-------------------|--------------------------------|--------------------|--|--------------------|
| Australia | A\$250,000 | \$179,598 | A\$2.5 million Net Assets | \$1.80 million |
| Canada | C\$200,000 Individual | \$149,622 | C\$5 million Net Assets | \$3.74 million |
| | C\$300,000 Joint Net Income | \$224,433 | C\$1 million Financial Assets | \$748,111 |
| European Union | N/A | N/A | €500,000 ¹²⁶ | \$529,151 |
| Israel | N/A | N/A | NIS 12 million ¹²⁷ | \$3.09 million |
| Singapore | S\$300,000 | \$212,307 | S\$2 million Net Personal Assets | \$1.42 million |
| United Kingdom | £100,000 | \$150,390 | £250,000 Net Assets | \$375,974 |

* Based on November 30, 2015 exchange rates.

Australia categorizes as “sophisticated investors” individuals with gross income of

¹²⁶ This component is part of a three-part test that also looks to professional experience and transaction history. Investors must satisfy two of these components. Directive 2010/73/EU, of the European Parliament and of the Council of 24 November 2010, Amending Directives 2003/71/EC on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market (O.J. L 327, 11.12.2010); Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (O.J. L 145, 30.4.2004).

¹²⁷ This component is part of a three-part test that also looks to professional experience and transaction history. Investors must satisfy two components. Securities Law 5728-1968 § 15A(a)(7) & (b)(1). *See also* Regulation of Investment Advising, Investment Marketing and Investment Portfolio Management Law 5755-1995 (First Schedule).

A\$250,000 or greater in each of the previous two years or net assets of at least A\$2.5 million.¹²⁸ Similarly, in Canada, an “accredited investor” is any natural person who earned net income of at least C\$200,000, or C\$300,000 combined with a spouse, in each of the past two years, or has net assets, alone or with a spouse, worth greater than C\$5 million.¹²⁹ Canada also uses a separate financial assets test under which individuals qualify as accredited investors if they own gross financial assets having an aggregate realizable value, before taxes but net of any related liabilities, exceeding C\$1 million, alone or with a spouse, that are generally liquid or relatively easy to liquidate, such as cash and liquid securities.¹³⁰ In the United Kingdom, all natural persons are presumed to be “retail” investors, and thus able to benefit from prospectus requirements and restrictions on securities promotion, unless they choose to be treated as “professional clients” or certify that they are either “certified high net worth individuals” or “sophisticated investors.”¹³¹ A certified high net worth individual is one who had an annual income of at least £100,000 in the preceding year or has net assets valued at £250,000 or more.¹³²

In Singapore, individuals are “accredited investors” if their net personal assets exceed S\$2 million or their income in the preceding 12 months is not less than S\$300,000.¹³³ The

¹²⁸ Corporations Act 2001 § 708(8); Regulation 6D.2.03.

¹²⁹ National Instrument 45-106 Prospectus Exemptions. The securities commissions in the individual provinces and territories are collectively referred to as the Canadian Securities Administrators (the “CSA”). They collaborate to adopt rules referred to as “National Instruments” that are generally adopted with identical language in each jurisdiction.

¹³⁰ *Id.*

¹³¹ Financial Services and Markets Act 2000, Chapter 8 § 21(2); Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, Part VI, Articles 48, 50 & 50A.

¹³² Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, Part VI, Article 48 (Schedule 5).

¹³³ Securities and Futures Act § 4A(1)(a)(i).

Monetary Authority of Singapore explains that “accredited investors are generally identified by income or wealth thresholds and considered to be sufficiently knowledgeable or experienced in managing their financial affairs (whether directly or through professional advice) and protecting their own investment interests.”¹³⁴

The methods for computing these financial criteria vary by country. Like the Regulation D accredited investor definition, some countries exclude certain types of assets from the net worth calculation. For example, the United Kingdom excludes the value of primary residences, loans taken out on primary residences, insurance rights and retirement and death benefits.¹³⁵

Criteria Based on Investment Amounts

Some jurisdictions have used a minimum investments test to determine whether an individual investor is sophisticated. Australia’s definition of sophisticated investor encompasses any purchase of securities greater than A\$500,000.¹³⁶ Canada had a prospectus exemption for purchases of C\$150,000 or greater by an individual, but in February 2015 the CSA adopted amendments to eliminate the exemption.¹³⁷ Provisions like this extend the analog of accredited

¹³⁴ Monetary Authority of Singapore, *Consultation Paper on Proposals to Enhance Regulatory Safeguards for Investors in the Capital Markets* (July 2014), available at http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/2014_07_21_final%20Enhance%20reg%20safeguards%20for%20investors.pdf.

¹³⁵ Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, Part VI, Article 48 (Schedule 5).

¹³⁶ Corporations Act 2001 § 708(8). This includes situations where the amount payable on acceptance of the offer, when added to amounts previously paid by the individual for the same class of the issuer’s securities held by the individual, equals at least A\$500,000. Corporations Act 2001 § 708(8)(b).

¹³⁷ The CSA cited concerns that the minimum investment amount prospectus exemption may not be a proxy for sophistication or ability to withstand financial loss for individual investors and may encourage over-concentration in one investment. CSA Notice of Amendments to National Instrument 45-106 *Prospectus and Registration Exemptions* (Feb. 2015), available at https://www.bccsc.bc.ca/Securities_Law/HistPolicies/HistPolicy4/PDF/CSA_Note_February_19_2015/.

investor status to the purchaser regardless of whether or not the individual would qualify under other sophistication measures.

Certification or Verification by Financial Professionals

The United Kingdom provides that investors may be deemed to be sophisticated if they have a written certificate signed within the last 36 months by a firm confirming that it has assessed the individual as sufficiently knowledgeable to understand the risks associated with engaging in investment activity in the relevant investments.¹³⁸ Alternatively, investors can certify that they are “self-certified sophisticated investors.”¹³⁹

In Australia, a qualified accountant must certify that an individual meets the net assets and gross income requirements in a certificate given no more than six months before the offer of securities is made.¹⁴⁰ In the European Union, it is the responsibility of the issuer or the financial intermediary to ensure that an individual meets the exemptive criteria and thus may be deemed a “qualified investor.”¹⁴¹

Financial Experience

Some jurisdictions combine financial thresholds with other measures of investor

¹³⁸ COBS § 4.12.7R.

¹³⁹ COBS § 4.12.8R. The certificate lasts for 12 months and must include particular warnings and confirmation that the investor has specific relevant, recent investment or business experience.

¹⁴⁰ Corporations Act 2001 § 708(8)(c).

¹⁴¹ Directive 2010/73/EU, of the European Parliament and of the Council of 24 November 2010, Amending Directives 2003/71/EC on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market (2010 O.J. L 327, 11.12.2010); Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (O.J. L 145, 30.4.2004).

sophistication to determine who is able to understand the risks of and bear the loss on private investments. For instance, in the European Union, an individual who meets at least two of the following three qualifications can opt to be treated as a “qualified investor” and participate in securities transactions that might not otherwise be available to ordinary retail investors:

- Cash deposits and other financial instruments in excess of €500,000.
- Sophistication based on previous market participation, including the execution, on average, of at least ten large transactions per quarter over the previous four quarters in the relevant financial market.
- Employment in the financial sector for at least one year in a professional position requiring knowledge of the market transactions contemplated.¹⁴²

In Israel, an individual who meets at least two of the following three conditions is considered a “qualified client” and is able to participate in private placements:

- Cash, deposits, financial assets and securities totaling in excess of NIS 12 million.
- Capital markets expertise and skills or work experience for at least one year in a professional position that required capital markets expertise.
- Execution of at least 30 transactions, on average, during each of the four previous quarters, other than transactions a portfolio manager performed for an investment management client.¹⁴³

As this summary indicates, a number of foreign jurisdictions also look to wealth or income as proxies for financial sophistication and those criteria provide bright-line standards. It is, however, noteworthy that some foreign jurisdictions also focus on a person’s investment experience by looking to factors such as the amount of investments owned, transaction history

¹⁴² *Id.* In addition, the investment firm also must provide clear written warnings about protections the investor might lose and the investor must prepare a separate written document stating he or she is aware of the consequences of losing such protections.

¹⁴³ Securities Law 5728-1968 § 15A(a)(7) & (b)(1). *See also* Regulation of Investment Advising, Investment Marketing and Investment Portfolio Management Law 5755-1995 (First Schedule).

and relevant professional experience.

IV. Accredited Investor Attributes

The accredited investor definition as applied to natural persons has been the subject of significant commentary and study. Commission requests for comment in connection with recent rulemaking initiatives have yielded hundreds of comment letters.¹⁴⁴ The GAO Report, mandated by the Dodd-Frank Act and published in 2013, examined market participants' views on the existing criteria for accredited investor status and alternative criteria. The Commission's Investor Advisory Committee and the Commission's Advisory Committee on Small and Emerging Companies both have provided the Commission with their recommendations on the accredited investor definition and several of the recommendations from the 2014 SEC Government-Business Forum on Small Business Capital Formation relate to the definition.¹⁴⁵ This section examines the current definition, common criticisms of the definition, various views on whether the definition should be modified and potential ways of doing so.

¹⁴⁴ On July 10, 2013, the Commission proposed amendments to Regulation D, Form D and Rule 156 (Release No. 33-9416). The proposing release requested public comment on the definition of accredited investor as it relates to natural persons. Comment letters related to this request are available at <http://www.sec.gov/comments/s7-06-13/s70613.shtml>. To facilitate public input on Dodd-Frank Act rulemaking, before the issuance of rule proposals, the Commission invited members of the public to make their views known on various regulatory initiatives under the Dodd-Frank Act in advance of any rulemaking. Comment letters submitted in response to this invitation are available at <http://www.sec.gov/comments/df-title-iv/accredited-investor/accredited-investor.shtml>. On August 3, 2007, the Commission proposed revisions to the limited offering exemptions in Regulation D (Release No. 33-8828). The proposing release requested public comment on various matters related to Regulation D. Comment letters related to this request are available at <http://www.sec.gov/comments/s7-18-07/s71807.shtml>.

¹⁴⁵ Recommendation of the Investor Advisory Committee: Accredited Investor Definition (Oct. 9, 2014) (the "Investor Advisory Committee Recommendation"), available at <http://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf>; Advisory Committee on Small and Emerging Companies: Recommendations Regarding the Accredited Investor Definition (Feb. 17, 2015) (the "ACSEC Recommendations"), available at <http://www.sec.gov/info/smallbus/acsec/acsec-accredited-investor-definition-recommendation-030415.pdf>; Final Report of the 2014 SEC Government-Business Forum on Small Business Capital Formation (May 2015) (the "Small Business Forum Report"), available at <http://www.sec.gov/info/smallbus/gbfor33.pdf>.

One of the primary objectives of Regulation D is to facilitate capital formation by simplifying the rules and regulations applicable to small businesses.¹⁴⁶ The accredited investor definition for individuals consists of bright-line financial thresholds that are relatively easy to understand and administer, and some commenters note that Regulation D should remain streamlined and easy for small businesses to use.¹⁴⁷

A. Current Definition

Under the current definition, natural persons are accredited investors if their income or net worth exceeds certain thresholds.

Income

The Commission originally adopted the \$200,000 annual income threshold in 1982¹⁴⁸ and added the provision for joint income in 1988.¹⁴⁹ These thresholds have never been adjusted.

Rule 501(a)(6)¹⁵⁰ does not define the term “income.” The Commission originally proposed to base the income standard on “individual adjusted gross income...as reported for Federal income tax purposes in [the] most recent tax return.”¹⁵¹ At adoption, however, the Commission chose a more flexible approach by changing the term “adjusted gross income” to

¹⁴⁶ See Regulation D Adopting Release.

¹⁴⁷ See, e.g., letters from Eugene B. Shanks, III (Sept. 23, 2013); SVB Financial Group (Sept. 23, 2013); Adam Geller (Aug. 20, 2013).

¹⁴⁸ Regulation D Adopting Release. Table 4.1 shows the impact of inflation on the \$200,000 threshold. See Section II.D for a historical discussion of the adoption of Regulation D.

¹⁴⁹ Regulation D Revisions Adopting Release.

¹⁵⁰ 17 CFR 230.501(a)(6).

¹⁵¹ Regulation D Proposing Release.

“income.”¹⁵² The Commission noted commenter objections that adjusted gross income may not be an appropriate metric for foreign investors, persons who file jointly or reside in a community property state or persons who use legitimate tax planning measures to reduce their adjusted gross income. The adopting release provided one possible method of calculating income: adjusted gross income plus the amounts of any deductions for long-term capital gains and depletion, any exclusions for interest and any limited partnership losses. Commission staff also has indicated that income includes amounts contributed on a person’s behalf to profit-sharing and pension plans so long as the person’s rights to the benefits have vested,¹⁵³ but that income generally does not include unrealized capital appreciation.¹⁵⁴

Net Worth

The Commission originally adopted the \$1 million net worth threshold in 1982¹⁵⁵ and revised it in 2011 to reflect changes made by the Dodd-Frank Act that excluded the value of a person’s primary residence from the calculation.¹⁵⁶ The \$1 million threshold has not otherwise been adjusted.

¹⁵² Regulation D Adopting Release.

¹⁵³ See Securities Act Rules Compliance and Disclosure Interpretation 255.16 (Jan. 26, 2009). See also Raymond, James & Associates, Inc., SEC Division of Corporation Finance Interpretive Letter (Dec. 19, 1984). The staff also has expressed the view that a person who has the same marital status during the three-year period in which income is measured must satisfy the income test in the same way (that is, based on either individual income or joint income) in all three years. See Securities Act Rules Compliance and Disclosure Interpretation 255.15 (Jan. 26, 2009).

¹⁵⁴ See Interpretive Release on Regulation D, Release No. 33-6455 (Mar. 3, 1983) [48 FR 10045] (the “Regulation D Interpretive Release”) at Q. 23.

¹⁵⁵ Regulation D Adopting Release. Table 4.1 shows the impact of inflation on the \$1 million threshold. See Section II.D for a historical discussion of the adoption of Regulation D.

¹⁵⁶ Primary Residence Adopting Release.

The Commission originally proposed an individual net worth threshold of \$750,000.¹⁵⁷ Some commenters recommended excluding certain assets, such as principal residences and automobiles, from the net worth calculation.¹⁵⁸ In response to those comments and for the sake of simplicity, the Commission increased the net worth threshold to \$1 million but did not exclude any assets from the calculation. The Commission also modified the net worth standard to include joint net worth in response to comments.¹⁵⁹

Rule 501(a)(5)¹⁶⁰ does not define the term “net worth.” However, when calculating net worth, the rule excludes the value of a person’s primary residence and includes as a liability indebtedness secured by a person’s primary residence in excess of the estimated fair value of the residence. Commission staff also has indicated that “[n]et worth is simply the excess of assets over liabilities”¹⁶¹ and that “assets in an account or property held jointly with a person who is not the purchaser’s spouse may be included in the calculation for the net worth test, but only to the extent of his or her percentage ownership of the account or property.”¹⁶²

B. Criticisms of the Current Definition

Some commenters state that the current accredited investor definition is over-inclusive

¹⁵⁷ Regulation D Proposing Release.

¹⁵⁸ *See* Regulation D Adopting Release.

¹⁵⁹ Commenters indicated that limiting net worth to that of an individual investor presented problems for investors in community property states and investors who held assets jointly with their spouses.

¹⁶⁰ 17 CFR 230.501(a)(5).

¹⁶¹ Securities Act Rules Compliance and Disclosure Interpretation 255.14 (Jan. 26, 2009) (indicating that vested employee stock options may be included in the calculation of net worth under Rule 501(a)(5)).

¹⁶² Securities Act Rules Compliance and Disclosure Interpretation 255.49 (July 3, 2014).

because the financial thresholds contained in the definition have not been adjusted for inflation¹⁶³ or because the net worth calculation includes certain assets, such as retirement accounts, that should be omitted.¹⁶⁴ Other commenters state that the accredited investor definition as it applies to individuals is under-inclusive because financially sophisticated individuals who are not wealthy may not qualify.¹⁶⁵ Many commenters question the correlation between wealth and financial sophistication and, as a result, feel that the income and net worth tests simply fail to identify correctly those individuals who should be accredited investors.¹⁶⁶

Some academic studies lend support to the theory that wealth is correlated to financial sophistication. For example, one study found evidence that individuals with higher net worth or income did not engage in most “irrational” investor behaviors as frequently as lower net worth individuals.¹⁶⁷ Another study based on trading records of more than 50,000 individuals from a

¹⁶³ See, e.g., letters from North American Securities Administrators Association, Inc. (Sept. 27, 2013) (the “2013 NASAA Letter”); AFL-CIO (Sept. 23, 2013) (the “AFL-CIO Letter”); Investment Company Institute (Sept. 23, 2013) (the “ICI Letter”).

¹⁶⁴ See, e.g., letter from J. Robert Brown, Jr. (Oct. 28, 2013) (the “Brown Letter”); Investor Advisory Committee Recommendation.

¹⁶⁵ See, e.g., letter from Rebecca L. Eisenberg (Nov. 4, 2013). Some commenters also have expressed the view that the accredited investor definition is both over- and under-inclusive because certain financially sophisticated individuals may not qualify, while wealthy, financially unsophisticated individuals may. See, e.g., Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 Cal. L. Rev. 279 (2000); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC’s “Accredited Investor” Definition Under the 1933 Act*, 86 Wash. U. L. Rev. 733 (2009); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 Okla. L. Rev. 291 (1994); Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. Legis. & Pub. Pol’y 251 (2008).

¹⁶⁶ See, e.g., 2013 NASAA Letter; letter from Consumer Federation of America (Sept. 23, 2013); Investor Advisory Committee Recommendation.

¹⁶⁷ Annette Vissing-Jorgensen, *Perspectives on Behavioral Finance: Does “Irrationality” Disappear with Wealth? Evidence from Expectations and Actions*, NBER Macroeconomics Annual 2003, Vol. 18. The study identified the following “irrational” investor behaviors: (1) delayed selling of losing investments in the hopes of recovery; (2) limited diversification of stock portfolios; (3) limited asset market participation; (4) naïve diversification of retirement account contributions; (5) status quo bias in retirement account allocations and (6) excessive trading. Excessive trading was the main exception to the study’s finding. The

large brokerage firm between 1991 and 1996 found empirical evidence that wealthier individuals and individuals employed in professional occupations exhibit a lower tendency to delay selling investments on which they have incurred losses in the hope that they will recover them.¹⁶⁸ In addition, a 2009 paper sought to measure the financial sophistication of households by constructing a financial sophistication index to explain the investment mistakes of under diversification, inertia in risk taking and delayed selling of investments on which households have incurred losses in the hope that they will recover them.¹⁶⁹ Using the entire population of Sweden as a data set, the study concluded that the financial sophistication index increased strongly with wealth. The study also summarized existing empirical literature, noting that “growing empirical literature documents a cross-sectional correlation between household characteristics and investment mistakes. Richer, better educated households tend to be better diversified, display less inertia, and have a weaker disposition to hold losing and sell winning stocks than other households.” Financial literacy surveys reflect similar results. For example, a 2012 study by the Financial Industry Regulatory Authority (“FINRA”) Investor Education Foundation found that higher income individuals correctly answered 3.5 out of five questions on a financial literacy quiz compared to only 2.2 correct responses for lower income individuals.¹⁷⁰ The reasons underlying the correlation between wealth and sophistication found in the studies

study was based on information obtained from UBS PaineWebber/Gallup on U.S. individual investors.

¹⁶⁸ Ravi Dhar and Ning Zhu, *Up Close and Personal: Investor Sophistication and the Disposition Effect*, *Management Science*, Vol. 52, No. 5 (2006).

¹⁶⁹ Laurent E. Calvet, John Y. Campbell and Paolo Sodini, *Measuring the Financial Sophistication of Households*, *American Economic Review*, Vol. 99, No. 2 (2009).

¹⁷⁰ *Financial Capability in the United States – 2012 Report of National Findings*, FINRA Investor Education Foundation (May 2013), available at http://www.usfinancialcapability.org/downloads/NFCS_2012_Report_Natl_Findings.pdf.

and surveys are not definitively known. Higher net worth and higher income investors may make more rational investment decisions based on past investing experience or outside factors such as education levels or by learning through social interactions.¹⁷¹ They may also have more access to information and technology and may more frequently use outside professional advisors. Regardless of the underlying reasons, however, these findings appear to support the continued use of financial thresholds as one method of qualifying as an accredited investor.

C. Potential Adjustments to Income and Net Worth

A number of commenters recommend potential adjustments to the accredited investor definition as it relates to the income and net worth thresholds. These potential adjustments range from changing the thresholds themselves to implementing revised or alternative financial criteria.

Adjustments to the Income and Net Worth Thresholds

As previously noted, the individual income threshold has not been adjusted since 1982, the joint income threshold has not been adjusted since 1988 and the net worth threshold has only been revised since 1982 to exclude the value of a person's residence. In 2007, the Commission proposed adjusting the thresholds for inflation on a going-forward basis every five years beginning in 2012.¹⁷² The Commission noted a staff report indicating that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the accredited investor standard."¹⁷³ The Commission further noted that not

¹⁷¹ See, e.g., Jeffrey R. Brown, Zoran Ivković, Paul A. Smith and Scott Weisbenner, *Neighbors Matter: Causal Community Effects and Stock Market Participation*, *Journal of Finance*, Vol. 63, No. 3 (2008). See also, Luigi Guiso and Tullio Jappelli, *Awareness and Stock Market Participation*, *Review of Finance*, Vol. 9, No. 4 (2005).

¹⁷² 2007 Proposing Release. The adjustment would have reflected any changes in the value of the PCE (or any successor thereto) from December 31, 2006.

¹⁷³ 2007 Proposing Release, quoting *Implication of the Growth of Hedge Funds*, Staff Report to the U.S.

adjusting the thresholds for inflation has effectively lowered them.¹⁷⁴ The Commission, however, noted that raising the thresholds significantly may have undesirable results if issuers return to the practice of conducting private placements under the Section 4(a)(2) statutory exemption rather than Regulation D.¹⁷⁵

As Table 4.1 indicates, inflation has eroded considerably the individual income and net worth thresholds since their adoption in 1982 and the joint income threshold since its adoption in 1988.¹⁷⁶

Table 4.1 Inflation Adjustments

| | Current Standard | Current Standard Adjusted for Inflation (CPI) | Current Standard Adjusted for Inflation (PCE) |
|--------------------------|-------------------------|--|--|
| Individual Income | \$200,000 | \$490,819 | \$432,265 |
| Joint Income | \$300,000 | \$600,558 | \$528,906 |
| Net Worth | \$1,000,000 | \$2,454,093 | \$2,161,326 |

Table 4.2 provides information about the approximate number and percentage of U.S. households that qualified as accredited investors in 1983, qualify as accredited investors currently, and would qualify as accredited investors if the thresholds were adjusted for

Securities and Exchange Commission (Sept. 2003) (the “Staff Hedge Fund Report”), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

¹⁷⁴ 2007 Proposing Release.

¹⁷⁵ The undesirable results the Commission noted were expenses and complications of multi-state securities law compliance, case law uncertainty associated with the Section 4(a)(2) exemption and the lack of Form D filings.

¹⁷⁶ Information in the table is based on August 31, 2015 CPI and PCE data and does not reflect the exclusion of the primary residence from the net worth thresholds.

inflation.¹⁷⁷ Information about the number of qualifying households that actually participate as accredited investors in private securities offerings is not available.

Table 4.2 Number and Percentage of Accredited Investor Households

| Basis for Qualifying as Accredited Investor | Number (in Millions) and Percentage of Qualifying Households* | | | | | | | |
|---|---|------|----------------------------|-------|---------------------------------|------|---------------------------------|------|
| | Current Thresholds in 1983 | | Current Thresholds in 2013 | | CPI Adjusted Thresholds in 2013 | | PCE Adjusted Thresholds in 2013 | |
| | # | % | # | % | # | % | # | % |
| Individual Income | 0.44 | 0.5% | 8.07 | 6.6% | 2.11 | 1.7% | 2.41 | 2.0% |
| Net Worth** | 1.42 | 1.7% | 9.22 | 7.5% | 3.86 | 3.1% | 4.49 | 3.7% |
| Individual Income or Net Worth | 1.51 | 1.8% | 12.40 | 10.1% | 4.37 | 3.6% | 5.06 | 4.1% |

* Total number of households equaled 83.9 million in 1983 and 122.5 million in 2013.

** Net worth calculations for 2013 exclude the value of primary residences.

The 1.51 million households qualifying in 1983 represented approximately 1.8% of U.S. households, while the 12.38 million qualifying in 2013 represented approximately 10.1% of U.S. households. Adjusting the income and net worth thresholds for inflation would reduce significantly the number of individuals that qualify as accredited investors under those tests. Using CPI, the percentage of qualifying households would fall to approximately 3.6% of total households and using PCE the percentage would fall to approximately 4.1%. In each case, however, the number of qualifying households would still be approximately three times as large as in 1983.

¹⁷⁷ Information in the table is based on data from the Federal Reserve Board's *Survey of Consumer Finances* (the "SCF") for 1983 and 2013. The SCF is a triennial survey. See Section X for definitions of income and net worth used in the analysis. The income and net worth data underlying the number of qualifying households is estimated in 2015 dollars.

Some commenters favor raising the financial thresholds based on investor protection concerns.¹⁷⁸ Commenters opposed to any increase cite the critical importance of the exempt offering market to the economy, arguing that decreasing the size of the accredited investor pool by raising the thresholds would adversely affect the market and small businesses seeking capital.¹⁷⁹ Raising the financial thresholds could restrict some investors' access to investments that are uncorrelated to their existing investment portfolios, thereby restricting their ability to diversify the risk of investment loss. Additionally, some commenters are concerned that raising the financial thresholds in the accredited investor definition would have a disproportionate impact in less wealthy areas of the country.¹⁸⁰

Some commenters support automatic inflation adjustments to the financial thresholds¹⁸¹ while others opposed automatic adjustments.¹⁸² One commenter notes that automatic inflation adjustments could eventually result in Investment Company Act Section 3(c)(1)¹⁸³ funds having

¹⁷⁸ See, e.g., 2013 NASAA Letter; AFL-CIO Letter; ICI Letter.

¹⁷⁹ See, e.g., letters from National Small Business Association (Sept. 23, 2013); South Carolina Small Business Chamber of Commerce (Sept. 17, 2014) (the "SCSBCC Letter"); Angel Capital Association (Feb. 28, 2014). Many "angel investors" also have submitted comment letters echoing the concerns expressed in this letter. Some commenters oppose increasing the thresholds but did not cite market impacts. See, e.g., letters from Gunderson Dettmer (Sept. 23, 2013) (the "Gunderson Dettmer Letter") (stating that the current thresholds are appropriate and that net worth is a reasonable proxy for determining investor sophistication, but the definition should be expanded to include alternative criteria); Real Estate Investment Securities Association (Sept. 23, 2013) (stating that the current thresholds are sufficient to ensure that investors have the financial sophistication to make an investment determination and the ability to absorb losses).

¹⁸⁰ See, e.g., SCSBCC Letter; letter from Small Business Investor Alliance (Oct. 8, 2014).

¹⁸¹ See, e.g., ACSEC Recommendations; letter from WealthForge (Sept. 23, 2013) (suggesting inflation adjustments on a going-forward basis to the extent the Commission decides to change the income and net worth thresholds).

¹⁸² See, e.g., letter from Managed Funds Association (Oct. 19, 2007) (the "2007 MFA Letter").

¹⁸³ 15 USC 80a-3(c)(1).

higher thresholds than Section 3(c)(7) funds.¹⁸⁴

Adjustments to the Calculation of Income and Net Worth

As noted above, Regulation D does not define the term “income” and only limited guidance exists about its interpretation. Some commenters suggest that specifically excluding certain income sources or using an alternative term, such as “disposable income,” would more appropriately capture the set of individuals with sufficient discretionary funds to bear investment risks.¹⁸⁵

With respect to net worth, the Dodd-Frank Act excluded the value of primary residences from the accredited investor net worth calculation¹⁸⁶ and the Commission excluded any positive equity individuals have in their primary residences.¹⁸⁷ Some commenters suggest that other asset categories, such as retirement assets, also should be excluded from the calculation.¹⁸⁸ Table 4.3¹⁸⁹ illustrates the effect that excluding retirement assets would have on the number and percentage of U.S. households that qualify as accredited investors based on net worth.

¹⁸⁴ 2007 MFA Letter.

¹⁸⁵ *See, e.g.*, letters from Karen Orso (Sept. 5, 2013); Kriss Kirchhoff (Aug. 15, 2013).

¹⁸⁶ Dodd-Frank Act § 413(a).

¹⁸⁷ Primary Residence Adopting Release.

¹⁸⁸ *See, e.g.*, Brown Letter; Investor Advisory Committee Recommendation.

¹⁸⁹ Information in the table is based on the SCF for 2013. As used in the SCF, retirement assets are quasi-liquid assets that include IRA/KEOGH accounts, thrift-type retirement accounts, future pension assets and current pension assets.

Table 4.3 Exclusion of Retirement Assets from Net Worth Calculation

| | Including Retirement Assets | | Excluding Retirement Assets | |
|---|-----------------------------|---------------------------|-----------------------------|---------------------------|
| | Number of Households* | Percentage of Households* | Number of Households* | Percentage of Households* |
| Current Net Worth (\$1,000,000) | 9.21 | 7.5% | 6.75 | 5.5% |
| Inflation Adjusted (CPI) Net Worth (\$2,454,093) | 3.86 | 3.1% | 3.05 | 2.5% |
| Inflation Adjusted (PCE) Net Worth (\$2,161,326) | 4.48 | 3.7% | 3.34 | 2.7% |

* Number of households in millions. Percentages based on 122.5 million total households.

Of the 12.4 million U.S. households that currently qualify as accredited investors, 2.5 million, or approximately 20.3%, are comprised solely of retirees.¹⁹⁰ Commenters who support excluding retirement assets argue that those assets are not an indicator of sophistication and that the illiquid nature of private offerings poses risks to retirees who depend on their investments as a source of regular income.¹⁹¹ In addition, excluding retirement assets from the net worth calculation could have a more proportionate impact across the country than raising the income or net worth thresholds, which may have a disproportionate impact in less wealthy areas.¹⁹² Excluding retirement assets, however, could have the unintended consequence of discouraging individuals seeking to meet the net worth threshold from contributing to retirement plans or even

¹⁹⁰ Based on the SCF for 2013.

¹⁹¹ See, e.g., Brown Letter; Investor Advisory Committee Recommendation.

¹⁹² Households in the South region of the United States have the lowest mean and median net worth relative to households in the other three regions (Northeast, Midwest and West). In 2013, the median net worth for a household in the South region was \$69,500 compared to \$129,800 for a household in the Northeast region. Retirement account values show a similar trend. Federal Reserve Board, *2013 SCF Chartbook*, available at <http://www.federalreserve.gov/econresdata/scf/files/BulletinCharts.pdf>.

encouraging them to withdraw assets from retirement plans. In addition, defining what assets are included in or excluded from the term “retirement assets” could be difficult.¹⁹³

Percentage-Based Adjustments to Income and Net Worth

Currently, the income and net worth financial thresholds are based on fixed dollar amounts and the results are absolute. An individual who exceeds the income or net worth threshold by one dollar can invest an unlimited amount in private offerings, while an individual who falls below the thresholds by one dollar cannot invest any amount at all. Including investment thresholds or limitations in the accredited investor definition based on a percentage of net worth or income would lead to less absolute results.

Other Commission rules contain investment limitations. For example, amended Regulation A limits the amount of securities non-accredited investors can purchase in certain of those offerings to no more than 10% of the greater of their annual income or their net worth.¹⁹⁴ In adopting the investment limitation, the Commission noted that the limits should help mitigate any concerns that non-accredited investors may be unable to absorb the potential loss of the investment.¹⁹⁵ In addition, recently adopted securities-based crowdfunding regulations¹⁹⁶ under Section 4(a)(6) of the Securities Act¹⁹⁷ contain aggregate individual investment limitations based on income and net worth.¹⁹⁸

¹⁹³ See ACSEC Recommendations.

¹⁹⁴ 17 CFR 230.251(d)(2)(i)(C).

¹⁹⁵ Regulation A+ Adopting Release.

¹⁹⁶ Crowdfunding, Release No. 33-9974 (Oct. 30, 2015).

¹⁹⁷ 15 USC 77d(a)(6).

¹⁹⁸ 17 CFR 227.100(a)(2). An investor is limited to investing, in aggregate across all issuers in a 12- month

Some commenters suggest permitting all individuals to invest up to a certain percentage of their income or net worth in private offerings.¹⁹⁹ Other commenters recommend allowing only individuals who exhibit some indicia of sophistication to invest a certain percentage of their income or net worth in private offerings.²⁰⁰ Similarly, the original accredited investor definition in Rule 501(a) provided that a person investing at least \$150,000 in an offering qualified as an accredited investor so long as the amount purchased did not exceed 20 percent of the person's net worth.²⁰¹ Permitting all individuals, or those who exhibit some indicia of financial sophistication, to invest in private offerings subject to an investment cap could expand significantly the accredited investor pool while limiting potential losses from any one specific investment. While investment limitations may be beneficial in limiting losses, they would not serve as proxies for financial sophistication or identify those individuals who are able to fend for themselves and thus may not, unless coupled with other relevant criteria, serve as effective

period (1) the greater of: \$2,000 or five percent of the lesser of the investor's annual income or net worth, if either annual income or net worth are less than \$100,000, or (2) ten percent of the lesser of the investor's annual income or net worth, not to exceed \$100,000, if both annual income or net worth are \$100,000 or more. These limitations apply to both accredited and non-accredited investors.

¹⁹⁹ See, e.g., letter from Joseph Karwat (Aug. 20, 2013) (suggesting that investors be permitted to invest up to five percent of their net worth plus income in start-up companies every year, regardless of income and net worth levels).

²⁰⁰ See, e.g., letters from National Investment Banking Association (Sept. 23, 2013) (the "NIBA Letter") (suggesting that individuals with relevant professional experience, academic credentials, or investment experience should be accredited with respect to some level of investment defined as a percentage of net worth or income); Stephanie Lee (Sept. 24, 2013) (suggesting an expansion of the accredited investor base by allowing for investments as a percentage of net worth from "qualified investors"); Angel Capital Group (July 22, 2014) (suggesting that "sophisticated" investors with incomes between \$50,000 and \$100,000 be permitted to invest up to five percent of their income, "sophisticated" investors with incomes between \$100,000 and \$200,000 be permitted to invest up to ten percent of their income, and "sophisticated" investors with incomes over \$200,000 be unrestricted in the amount they can invest).

²⁰¹ See Regulation D Adopting Release. The Commission eliminated the provision in 1988, noting that "size of purchase alone, particularly at the \$150,000 level, does not assure sophistication or access to information." Regulation D Revisions Adopting Release.

indicators of those individuals who do not require the protections of registration.

Some commenters suggest imposing limitations on the amount accredited investors can invest in private offerings.²⁰² This approach would not affect the size of the accredited investor pool, but could decrease the amount of capital available for investment in the private placement market.²⁰³ Imposing investment limitations could promote diversification and help to protect against accredited investors incurring unaffordable losses. Investment limitations could be implemented in any number of ways. For example:

- An investment limitation could apply evenly across the spectrum of accredited investors where all investors would be subject to the same percentage limitation. This approach would protect all accredited investors from substantial losses, but would adversely impact the accredited investors who are most able to incur losses.
- An investment limitation could gradually decrease as net worth or income increases until the limitation is eventually eliminated. This approach would protect those accredited investors who are least able to incur losses and have less of an impact on those accredited investors who are most capable.
- Separately or in conjunction with the above approaches, investment limitations could apply on a per issuer basis, a per investment basis or an aggregate investments per investor basis.

Some commenters, however, raise concerns that implementing any type of percentage-based investment limitation would add complexity to the accredited investor definition and may prove

²⁰² See, e.g., letters from AARP (Sept. 24, 2013) (the “AARP Letter”) (suggesting that, like the JOBS Act’s crowdfunding investment percentage limitation, “the Commission should consider whether there should be a limit on how much even an accredited investor can invest in a Rule 506 Regulation D offering”); Artinvest (Sept. 19, 2013) (the “Artinvest Letter”) (suggesting that investors should not be permitted to invest more than a certain percentage of net worth or liquid assets into certain types of products); Investor Advisory Committee Recommendation.

²⁰³ Because the current average private placement investment size is unknown, it is unclear how significantly investment limitations would affect the amount of capital available for investment in the private placement market. To the extent investors generally invest less than any contemplated limitations, the impact on available capital would be minimal.

to be difficult to administer.²⁰⁴

Alternatives to Net Worth

Several commenters suggest that the amount of a person's investments may be more accurate than a person's net worth as an indicator of sophistication and ability to fend for oneself.²⁰⁵ The GAO Report also indicates that this sentiment exists among market participants.

In 2007, the Commission proposed adding a \$750,000 "investments-owned" standard as an additional and alternative method of establishing accredited investor status.²⁰⁶ The Commission noted that an investments-owned standard was a potentially more accurate method of assessing an investor's need for the protections of registration under the Securities Act than existing standards. The Commission noted that \$750,000 "is the same as the dollar-amount threshold initially proposed in Regulation D for the asset test, which, as initially proposed, excluded certain assets, including personal residences. The assets threshold was increased to \$1 million and adopted for the sake of simplicity and reflected a \$250,000 increase in large part to account for the value of the primary residence." Commenters generally supported an investments-owned test.²⁰⁷

²⁰⁴ See, e.g., Gunderson Dettmer Letter (indicating that "[w]hile such a formula could, theoretically, produce a more appropriate test, we are not convinced that the benefits of such a formula outweigh the complexity in understanding and administering such a requirement.").

²⁰⁵ See, e.g., AARP Letter; ICI Letter; letter from Securities Regulation Committee of the Business Law Section of the New York State Bar Association (Sept. 23, 2013) (the "NYS Bar Letter"); Investor Advisory Committee Recommendation.

²⁰⁶ See 2007 Proposing Release.

²⁰⁷ See, e.g., 2007 MFA Letter; letters from Committees on Federal Regulation of Securities, Middle Market and Small Business, and State Regulation of Securities of the American Bar Association (Oct. 12, 2007) (the "ABA Letter"); North American Securities Administrators Association, Inc. (Oct. 26, 2007) (the "2007 NASAA Letter"); Investment Program Association (Oct. 9, 2007); Massachusetts Securities Division (Oct. 12, 2007) (the "Massachusetts Securities Division Letter"); National Association of Small Business Investment Companies (Oct. 8, 2007); National Venture Capital Association (Oct. 9, 2007) (the "NVCA

The Commission proposed to define “investments” based on the definition used in Investment Company Act Rule 2a51-1(b) for purposes of the “qualified purchaser” definition.²⁰⁸ As discussed above, in addition to securities, that definition includes real estate, physical commodities, commodity interests and financial contracts, in each case if held or entered into for investment purposes. When adopting Rule 2a51-1, the Commission noted that “the legislative history [of NSMIA] suggests that the asset should be held for investment purposes and that the nature of the asset should indicate that its holder has the investment experience and sophistication necessary to evaluate the risks of investing ...”²⁰⁹ Additionally, controlling interests in an issuer generally do not qualify as investments under Rule 2a51-1(b). The Commission noted that “limiting the definition in this manner is designed to exclude, among other things, controlling ownership interests in family-owned and other closely-held businesses.”²¹⁰

Some commenters characterized the 2007 proposed definition of investments as too narrow or proposed a more principles-based approach.²¹¹ A principles-based approach, however, may add additional subjective factors to the calculation of investments-owned or shift the focus

Letter”); John C. Melton (Oct. 9, 2007) (the “Melton Letter”).

²⁰⁸ The 2007 Proposing Release noted that the proposed definition is substantively the same as the definition proposed in December 2006 in the Private Pooled Investment Vehicle Release. The Private Pooled Investment Vehicle Release based the definition of investments on the Investment Company Act definition because it would provide a bright-line standard for ascertaining an investor’s status.

²⁰⁹ See Privately Offered Investment Companies Adopting Release. NSMIA required the Commission to define the term “investments” for purposes of the qualified purchaser definition.

²¹⁰ *Id.*

²¹¹ See, e.g., ABA Letter (suggesting a principles-based approach and questioning the exclusion of securities of private controlled companies); letter from Committee on Securities Law of the Business Law Section of the Maryland State Bar Association (Oct. 9, 2007) (the “Maryland State Bar Letter”) (suggesting that the proposed definition was unnecessarily narrow by excluding, for example, secondary residences).

away from investing experience. Other commenters stated that adopting the same definition as used in the Investment Company Act would promote issuer compliance and investor understanding.²¹²

Another possible approach to defining “investments” would be to limit the definition to investments in securities or liquid assets. The GAO Report described market participant support for the inclusion of an investment-based test measured by investments that could be easily liquidated to cover losses.²¹³ Regardless of the approach taken to define investments, an important consideration would be whether the definition contains bright-line standards that minimize the need for subjective evaluations.

D. Potential New Criteria

Many commenters who believe income and net worth are not accurate proxies for investor sophistication suggest alternative approaches for determining accredited investor status. Some commenters generally recommend including alternative measures of sophistication in the definition²¹⁴ while others suggest specific approaches based on criteria such as investors’ education, profession, investing experience, relationships with issuers, use of financial intermediaries and financial expertise. Although these criteria do not correlate to an investor’s ability to bear financial losses, some commenters suggest they may effectively identify persons who do not need the protections of registration.

²¹² See, e.g., letter from Katten Muchin Rosenman LLP (Oct. 9, 2007) (the “Katten Muchin Letter”).

²¹³ The GAO Report defined “liquid investments” as “assets that can be easily sold, are marketable, and the value of which can be verified by a financial institution.”

²¹⁴ See, e.g., ACSEC Recommendations; GAO Report.

Education

Many commenters state that certain educational backgrounds more appropriately reflect investor sophistication than financial metrics and have suggested criteria such as college degrees²¹⁵ and advanced degrees in relevant areas²¹⁶ for the accredited investor definition. While certain types of degrees likely imply knowledge in the areas of finance and investing,²¹⁷ a challenge with this suggested approach could be determining which degrees would be sufficient for an individual to qualify as an accredited investor. This approach could also be difficult to administer because of the different types of institutions that grant degrees. For example, should the Commission consider differently a graduate degree in finance from an unaccredited institution and an undergraduate business degree from a university with a well-established finance curriculum? This problem could be exacerbated when one considers the various career paths that degree holders can take. For instance, a corporate securities attorney and an environmental attorney both have law degrees, but, based on professional experience alone, it is probable that their knowledge of finance and investing is not equivalent.

Business Experience and Professional Certifications

Commenters also suggest that the accredited investor definition should consider an individual's financial and business sophistication and include criteria such as having operated a

²¹⁵ See, e.g., letter from Association for Corporate Growth (Sept. 23, 2013) (the "ACG Letter").

²¹⁶ See, e.g., NIBA Letter (suggesting post-graduate MBAs in business and/or finance); letters from Charles Sidman (Sept. 23, 2013) (the "Sidman Letter") (suggesting a Masters or Doctorate in business, economics or finance from an accredited educational institution); SeedInvest (June 8, 2014) (the "SeedInvest Letter") (suggesting a Masters of Business Administration; a masters or doctorate in finance, economics, business or a related field of study; and a Juris Doctor); EarlyShares.com (Aug. 4, 2014) (the "EarlyShares Letter") (suggesting a new designation for "sophisticated investors" to qualify as accredited investors, including individuals with relevant advanced degrees).

²¹⁷ See, e.g., Charlotte Christiansen, Juanna Schröter Joensen and Jesper Rangvid, *Are Economists More Likely to Hold Stocks?*, Review of Finance, Vol. 12, No. 3 (2008).

business or being a certified public accountant (“CPA”), chartered financial analyst (“CFA”), certified financial planner (“CFP”), investment adviser representative or broker-dealer registered representative.²¹⁸ Some commenters note that under the current accredited investor definition, individuals with relevant credentials may be qualified to provide advice to investors on private placement offerings, even though they may not qualify as accredited investors and may not be able to participate in the offerings in their personal capacities.²¹⁹

A challenge with this approach could be determining which professional certifications and designations would be sufficient for an individual to qualify as an accredited investor. Certain professional certifications and designations may, however, provide demonstrable evidence of investor sophistication. For example, FINRA administers a number of examinations that test an individual’s knowledge and understanding in the areas of securities and investing, and individuals must pass examinations to become CPAs, CFAs and CFPs.

- *Series 7 General Securities Representative Examination.* The Series 7 “qualifies a candidate for the solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal securities, municipal fund securities,

²¹⁸ See, e.g., Gunderson Dettmer Letter (stating that “being a CPA, CFA, attorney or registered investment adviser (to include someone who has taken and passed a Series 65 or 63 exam) represents an objective measure of one’s ability to understand the financial and business complexities associated with a private offering.”); Artivist Letter (suggesting that financial services professionals and others having financial experience, such as certified financial advisers and accountants, should be permitted to participate in Rule 506 offerings); SeedInvest Letter (suggesting individuals with professional designations (J.D., CPA, CFA, CSIP, etc.) or who hold securities licenses should be accredited); ACG Letter (suggesting business background as a factor that might be considered in determining whether an investor is accredited); EarlyShares Letter (suggesting a new designation for “sophisticated investors” to qualify as accredited investors, including individuals with relevant professional designations such as MBA, CFA and Series 7); letters from Certified Financial Planner Board of Standards, Inc. (Dec. 19, 2014) (stating that the CFP certification should be included in the event the Commission determines that certain degrees and certifications should qualify individuals as accredited investors); Intellivest Securities, Inc. (July 10, 2013) (suggesting alternative methods to become an accredited investor such as having a securities license or a CPA designation, admission to the bar, education or experience running a business); U.S. Representatives Patrick McHenry and Scott Garrett (Oct. 30, 2013); Investor Advisory Committee Recommendation; Small Business Forum Report.

²¹⁹ See, e.g., letter from CrowdFund Intermediary Regulatory Advocates (Aug. 25, 2014).

options, direct participation programs, investment company products, and variable contracts.”²²⁰

- *Series 65 Uniform Investment Adviser Law Examination.* The Series 65 is designed to qualify candidates as investment adviser representatives and covers topics necessary for adviser representatives to understand to provide investment advice to retail advisory clients.²²¹ NASAA developed the Series 65 examination and FINRA administers it.
- *Series 82 Limited Representative-Private Securities Offering Qualification Examination.* The Series 82 qualifies individuals seeking to effect the sales of private securities offerings.²²² It focuses on private transactions and is more limited in scope than the Series 7 examination. Because most individuals take the Series 7 examination, a relatively small number of individuals take the Series 82 examination in any year.
- *Uniform Certified Public Accountant Examination (the “CPA Exam”).* The CPA Exam consists of four sections designed by the American Institute of Certified Public Accountants, including a Business Environment and Concepts section. Among other topics, the Business Environment and Concepts section tests for knowledge of corporate governance, economics and finance.²²³
- *CFA Examinations.* The CFA program is designed to provide individuals with investment analysis and portfolio management skills. To become a CFA, an individual must complete three CFA Institute administered examinations and have four years of relevant professional work experience.²²⁴
- *CFP Examination.* The CFP Certification Examination is designed to assess an individual’s ability to apply financial planning knowledge to real-life financial planning situations.²²⁵

If individuals who passed third-party examinations designed for other purposes were deemed to

²²⁰ <http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/Qualifications/P011051>.

²²¹ <http://www.nasaa.org/industry-resources/exams/series-65-66-resources/series-65-study-guide/>.

²²² <http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p011064.pdf>.

²²³ <http://www.aicpa.org/BECOMEACPA/CPAEXAM/Pages/CPAExam.aspx>.

²²⁴ <http://www.cfainstitute.org/programs/cfaprogram/charterholder/Pages/index.aspx>.

²²⁵ <http://www.cfp.net/become-a-cfp-professional/cfp-certification-requirements/cfp-exam-requirement/about-cfp-exam>.

be accredited investors, the Commission may need to review periodically the definition to ensure that the standards underlying the examinations continue to identify persons having the requisite financial sophistication to invest in private securities markets. Another potential problem with this approach could be that some individuals who obtain certifications and designations may not practice in fields related to the certifications or designations. For these individuals, the validity of the credential as a proxy for financial sophistication could be lessened, especially if a substantial amount of time has elapsed since obtaining the certification or designation. This concern, however, could be mitigated for individuals who maintain active certifications or designations.

Use of Professionals

Some commenters believe that individuals who are advised by professionals should be considered accredited investors.²²⁶ Professionals may be able to evaluate the risks and benefits of a particular offering, and help their clients understand those risks and benefits. Regulation D, however, already contains a mechanism for individuals to participate in offerings made in reliance on Rule 506(b) by using “purchaser representatives” even if, acting alone, they may lack the requisite knowledge and experience to independently evaluate the merits and risks of the offerings.²²⁷ Purchaser representatives must be capable of evaluating the merits and risks of each

²²⁶ See, e.g., Artivest Letter (suggesting that financial services professionals, as well as certain others having financial experience, such as financial advisers, accountants, etc., should be permitted to invest in Rule 506 offerings); SeedInvest Letter (suggesting that individuals who have consulted a licensed expert and act in accordance with their recommendations should be deemed to be able to fend for themselves); letters from Investment Adviser Association (Sept. 23, 2013) (recommending that the Commission consider the GAO Report’s finding that some market participants supported alternative criteria such as use of an investment adviser); Morrison & Foerster LLP (Sept. 23, 2013) (the “Morrison Foerster Letter”) (suggesting including non-accredited investors advised by an “investment professional”).

²²⁷ Rule 506(b) allows up to 35 non-accredited investors to participate in an offering if they, alone or together with a purchaser representative, have such knowledge and experience in financial and business matters that

prospective investment.²²⁸ An issuer selling to these non-accredited individuals must provide them with certain information about the issuer, including financial information.²²⁹ Revising the accredited investor definition to include individuals advised by professionals appears to run counter to the Commission’s prior determination to allow persons who are unable to evaluate the merits and risks of private offerings to participate in those offerings only if the issuer provides them with additional information about the issuer. In addition, there may be significant overlap between individuals who receive advice from professionals and those who meet the existing financial standards in the accredited investor definition.²³⁰

Investing Experience in Private Markets

Some commenters recommend considering individuals’ investing experience,²³¹ possibly as evidenced by membership in an established “angel” investing group,²³² when determining whether they are accredited investors. Angel investors provide capital to start-up businesses,

they are capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that these investors come within this description.

²²⁸ “Purchaser representative” is defined in Rule 501(i). Other conditions to being a purchaser representative relate to a purchaser representative’s relationship to the issuer, disclosures a purchaser representative must provide the purchaser and a written acknowledgement from the purchaser. The Commission’s Investor Advisory Committee recommends prohibiting purchaser representatives from having any personal financial stake in the investment being recommended, prohibiting purchaser representatives from accepting compensation from the issuer and requiring purchaser representatives who are compensated by the purchaser to accept a fiduciary duty to act in the best interests of the purchaser. Investor Advisory Committee Recommendation.

²²⁹ Rule 502(b). In some cases, issuers must provide information equivalent to that which they would be required to provide in a registration statement. Given the adoption of amended Regulation A and securities-based crowdfunding rules, the Commission could consider whether scaled disclosure requirements are appropriate.

²³⁰ See Figure 10.5 and the accompanying text for additional information about the use of professionals by U.S. households that qualify as accredited investors.

²³¹ See, e.g., ACG Letter; Investor Advisory Committee Recommendation.

²³² See, e.g., Sidman Letter; Investor Advisory Committee Recommendation.

either individually or as a group of investors.²³³ A marketplace survey reported that, in 2014, there were approximately 316,600 active angel investors in the United States and angel investing funded 73,400 entrepreneurial ventures.²³⁴ According to the survey, the average angel deal size in 2013 was \$328,500. Angel investors appear to have an average of nine years of angel investing experience and have made an average of ten investments.²³⁵ Angel groups screen potential investments, perform due diligence, negotiate investment terms and make valuation determinations.²³⁶

The United Kingdom allows individuals to declare that they are “self-certified sophisticated investors” based on, among other criteria, having been a member in a network or syndicate of business angels for at least the last six months or having made more than one investment in an unlisted company in the last two years.²³⁷ These criteria may correlate to an individual’s knowledge of the private securities markets generally, including the risks associated with investing in those markets. Defining the angel groups that qualify, or the standards by

²³³ See generally Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. Pa. J. Bus. L. 107 (2010).

²³⁴ See Jeffrey Sohl, *The Angel Investor Market in 2014: A Market Correction in Deal Size*, Center for Venture Research (May 14, 2015).

²³⁵ See Angel Investors – Critical Initiators of Startups and Job Creation, Angel Capital Association, Government-Business Forum on Small Business Capital Formation (Nov. 21, 2013), available at <http://www.sec.gov/info/smallbus/sbforum112113-materials-mirabile.pdf> (indicating that angel investors have a median of nine years investing and a median of ten investments); Robert Wiltbank, *At the Individual Level: Outlining Angel Investing in the United States*, University of Illinois at Urbana-Champaign’s Academy for Entrepreneurial Leadership Historical Research Reference in Entrepreneurship (Feb. 2005) (finding that on average each investor had invested in nine investments over ten years); Robert Wiltbank and Warren Boeker, *Returns to Angel Investors in Groups*, Ewing Marion Kauffman Foundation and Angel Capital Education Foundation (Nov. 2007) (finding that the typical group-affiliated angel investor has been investing for just over nine years on average, and has made slightly more than one investment per year).

²³⁶ See Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*.

²³⁷ COBS § 4.12.8.

which such groups may qualify, however, could present significant interpretive challenges. If the definition included a minimum number of investments in private offerings as a criteria, it could be difficult for individuals who were not previously accredited investors to qualify because few non-accredited investors participate in such offerings.²³⁸ In addition, because not all types of exempt offerings give investors the relevant experience for Regulation D investments,²³⁹ the types of exempt offerings that qualify for this criteria may need to be limited.

Knowledgeable Employees

Several commenters recommend expanding the accredited investor definition to include an issuer's knowledgeable employees.²⁴⁰ Certain commenters²⁴¹ specifically recommend including "knowledgeable employees" of private funds as defined in Rule 3c-5 of the Investment Company Act.²⁴² That definition includes executive officers, directors, trustees, general partners, advisory board members, or persons serving in similar capacities, of the "covered company"²⁴³ or an "affiliated management person"²⁴⁴ of the covered company as well as employees who, in connection with their regular duties participate and have participated for at least twelve months,

²³⁸ There are ways individuals could conceivably qualify. For instance, an individual could participate as a non-accredited investor in Rule 505 or Rule 506(b) offerings, to the extent those opportunities are available.

²³⁹ For instance, participation in crowdfunding transactions.

²⁴⁰ See, e.g., Morrison Foerster Letter; NYS Bar Letter; Artivist Letter; letter from Managed Funds Association (Sept. 23, 2013) (the "2013 MFA Letter").

²⁴¹ See, e.g., NYS Bar Letter; 2013 MFA Letter.

²⁴² 17 CFR 270.3c-5.

²⁴³ "Covered companies" are private funds that fall within the scope of Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Investment Company Act Rule 3c-5(a)(2) & (5)-(6) (17 CFR 270.3c-5(a)(2) & (5)-(6)).

²⁴⁴ An "affiliated management person" is an affiliated person that manages the investment activities of a covered company. Investment Company Act Rule 3c-5(a)(1) (17 CFR 270.3c-5(a)(1)).

in a non-clerical or administrative manner, in investment activities.²⁴⁵ Rule 501(a)(4)²⁴⁶ of the accredited investor definition already includes officers, directors and general partners.

Expanding the definition in this manner would allow trustees, advisory board members and certain investment fund professionals to participate in their funds' private offerings. A private fund's knowledgeable employees likely have meaningful investing experience and sufficient access to the information necessary to make informed investment decisions about the fund's offerings.

Accredited Investor Examination

Some commenters recommend permitting individuals to become accredited investors by passing an examination that tests their investing and market knowledge.²⁴⁷ An accredited investor examination could be a universal criteria that would be available to anyone regardless of wealth, educational background, professional experience or any other factor. Individuals who are unable to qualify as accredited investors under any other criteria could take an examination as an alternative means to qualify.

Taking and passing an effectively designed accredited investor examination could reflect

²⁴⁵ 17 CFR 270.3c-5(a)(4).

²⁴⁶ 17 CFR 230.501(a)(4).

²⁴⁷ See, e.g., SeedInvest Letter (suggesting a standardized accredited investor test with publicly available results); EarlyShares Letter (suggesting that a licensing test be created); letter from SecondMarket (Sept. 18, 2013) (recommending an examination "much like the examination that a potential registered representative takes to obtain a Series 7 license, to determine a natural person's investment sophistication regardless of financial status"). See also Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal* (Dr. Choi's focus was broader than the accredited investor definition. He proposed shifting the Commission's regulatory focus from issuers to investors, with protections tailored to specific categories of investors.); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act* (suggesting a licensing scheme based on accredited investor status and knowledge where accredited investors would be required to pass a short licensing exam and non-accredited investors would be required to pass a longer exam to invest in exempt offerings); Investor Advisory Committee Recommendation; Small Business Forum Report.

individuals' financial sophistication and understanding of private offerings and their ability to appreciate the risks involved in those offerings. Requiring that examination results be relatively recent (*e.g.*, within five years) or requiring continuing education could help to ensure that investors remain informed of marketplace trends and risks and regulatory changes. Another advantage of an accredited investor examination is that issuers may be able to easily verify accredited investor status by asking investors for evidence that they have passed the examination. One academic also noted that an investor licensing model could increase the level of investment-related knowledge in the market.²⁴⁸

An accredited investor examination could include elements that test investors' knowledge of the risks present in unregistered offerings, as well as financial and investing concepts in general. Portions of FINRA's Series 7 and Series 82 examinations cover these areas and could potentially be used as a model for developing an accredited investor examination. Among other subjects, the Series 7 examination covers securities regulatory requirements, securities characteristics and financial analysis.²⁴⁹ Knowledge of the regulatory landscape is particularly important because individuals who invest in unregistered offerings should understand that they will generally not receive the type of information contained in a registration statement. The Series 7 examination consists of 250 multiple choice questions that candidates have six hours to complete. Among other subjects, the Series 82 examination similarly includes questions related to the regulation of the markets for registered and unregistered securities, securities

²⁴⁸ See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*.

²⁴⁹ http://www.finra.org/sites/default/files/Series_7_Outline.pdf.

characteristics and financial analysis.²⁵⁰ The scope of the Series 82 examination is more limited than the Series 7 examination because it focuses on private transactions. It contains 100 multiple choice questions that candidates have two-and-a-half hours to complete. Although these examinations may not test knowledge of every type of unregistered investment, they include a focus on private investments and the inherent risks in unregistered offerings.

Whether an accredited investor examination would be feasible depends on a number of factors, such as the cost of developing and administering the examination and the number of individuals who would take the examination. The Commission could explore the feasibility of developing an examination. If an accredited investor examination meeting the Commission's standards could be developed, the Commission could recognize the examination for purposes of meeting the accredited investor definition.

V. Should the Accredited Investor Definition Be More Flexible?

With limited exceptions,²⁵¹ individuals currently qualify as accredited investors based on fixed financial thresholds that apply to all transactions, irrespective of investor sophistication, the amount of information provided to investors or other transaction-specific factors. Many commenters recommend altering the current approach by looking to objective measures of sophistication as alternative accredited investor criteria.²⁵² Under such an approach, investors with greater levels of demonstrable sophistication could be accredited despite having lower levels of assets or income. The current definition also does not consider issuer-specific factors,

²⁵⁰ http://www.finra.org/sites/default/files/Series_82_Outline.pdf.

²⁵¹ Rule 501(a)(4) provides that directors, executive officers and general partners of the issuer and its general partners qualify as accredited investors.

²⁵² *See, e.g.*, NYS Bar Letter; NIBA Letter.

such as whether the issuer is an operating company versus an investment fund. This section considers the implications of adopting more flexible, issuer- and transaction-specific approaches to the accredited investor definition.

A. Opportunities for Scaling

Sliding scale requirements could be based on a variety of criteria related to specific investors and transactions.

Type of Information Provided

Currently, Regulation D requires issuers in Rule 505 and 506(b) offerings to provide the financial and non-financial information specified in Rule 502(b) to prospective purchasers that are not accredited investors.²⁵³ Issuers in accredited investor-only offerings, including those made under Rule 506(c), have no such requirement. Nevertheless, companies and funds conducting private accredited investor-only offerings often provide prospective purchasers with some information about the issuer. The provision of issuer information to prospective purchasers in private offerings may provide an opportunity for scaling the financial thresholds in the accredited investor definition.

For example, the accredited investor definition could establish reduced financial thresholds that would expand the pool of accredited investors for offerings in which an issuer provides investors with prescribed information, such as audited financial statements. Under this potential framework, issuers relying on Rule 505 or 506 could sell securities:

- Exclusively to accredited investors under the default financial thresholds, without being required to provide financial or non-financial information;

²⁵³ A note to Rule 502(b)(1) indicates that when an issuer provides information to non-accredited investors, it should consider providing the information to accredited investors as well.

- To persons meeting reduced financial thresholds, if the issuer provides, for example, audited financial statements; or
- To non-accredited investors, if the issuer provides the financial and non-financial information required by Rule 502(b).²⁵⁴

While including scaled financial thresholds in the accredited investor definition based on information provided to investors could afford issuers additional flexibility in conducting their offerings, it would add complexity to the definition and could increase transaction costs. These consequences could be offset by the larger pool of potential investors and an increased amount of capital available to invest in the offerings, which could reduce the cost of capital for issuers.

Type of Offering or Issuer

A more particularized approach to the accredited investor definition could require investors to meet heightened qualification standards for offerings with more intrinsic risks or complexities. While private fund investments may offer some advantages over investing in operating companies,²⁵⁵ in 2006 the Commission noted that private pools have become increasingly complex and involve risks generally not associated with many other securities issuers.²⁵⁶ The regulation of private securities offerings based on risk levels, however, may not be feasible because of the challenge of categorizing investment risks and the possibility that some risks may erode or fluctuate over time.

²⁵⁴ This option would not apply to Rule 506(c) offerings, which are limited to accredited investors only.

²⁵⁵ See, e.g., John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 Yale L. J. 1228 (2014) (noting that investors in investment funds, such as hedge funds, can move their money by redeeming their investments, while investments in operating companies may be locked in and not removed unless companies pay dividends).

²⁵⁶ Private Pooled Investment Vehicle Release (restating concerns expressed in the Staff Hedge Fund Report).

Contextual Approach

Alternatively, or in conjunction with the objective criteria described above, a more flexible approach could involve a contextual evaluation of an investor's attributes with respect to a particular offering. For example, in conjunction with scaled financial criteria, the accredited investor definition could use the fact-specific and contextual provisions of former Rule 146, under which investors could be accredited for some offerings but not others.²⁵⁷ The Supreme Court in *Ralston Purina* also used a contextual approach by looking to the ability of offerees to obtain information about the offering. The concept of accrediting a narrow class of individuals deemed to be able to fend for themselves based on their knowledge and access to information, even if those individuals would not otherwise meet the specific criteria in the accredited investor definition, is an additional example of the contextual approach.

Layered Approach

The accredited investor definition could layer a scaled approach onto existing or proposed accredited investor criteria. For example, two sets of financial criteria could be established – one set at the current thresholds that would be subject to absolute or percentage-based investment limitations and another set with higher thresholds that would not be subject to investment limitations. Similarly, absolute or percentage-based investment limitations could be imposed for individuals who do not meet certain financial thresholds, but who do meet other non-financial indicia of financial sophistication.

²⁵⁷ Former Rule 146(e) required that offerees either have access to or have been provided with the same kind of information specified in Schedule A of the Securities Act. A note to the rule explained that access could only exist by reason of the offeree's position with respect to the issuer, and that position meant employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer to evaluate the merits and risks of the prospective investment.

B. Advantages and Disadvantages of Scaling

Scaling provides opportunities to more closely mirror the considerations outlined in *Ralston Purina* than using fixed financial thresholds. Scaling could also yield more tailored results for investors and issuers. This benefit could be significant because while Regulation D originated as an effort to assist small business capital formation, today all sizes and classes of issuers rely on Regulation D for their offerings.²⁵⁸ A more flexible approach would perhaps better reflect the diversity of issuers that depend on Regulation D and individuals that seek to participate in these offerings. Scaling could also expand the pool and categories of eligible investors to reflect changes in the marketplace that have occurred since the adoption of Regulation D, including the increased amount of information available to many retail investors.

Another benefit of a more flexible approach is that it may better identify the persons the accredited investor definition was intended to cover. The definition was intended to encompass those individuals whose financial sophistication and ability to sustain investment losses or fend for themselves render Securities Act registration unnecessary. A test that addresses all of these characteristics could result in a more calibrated definition. For example, it may not be appropriate to accredit individuals based on financial sophistication alone because financial sophistication does not necessarily have any bearing on an individual's ability to sustain losses or ability to obtain the information necessary to evaluate an offering. If an individual, however, has the financial sophistication to ask for and evaluate information to decide whether and how much to invest, and the bargaining power to obtain the information, then it may not be necessary for that individual to demonstrate that he or she has the ability to sustain losses.

²⁵⁸ See 2007 Proposing Release. See also Unregistered Offerings White Paper.

On the other hand, the flexibility associated with scaling may increase uncertainty and complexity in the application of the accredited investor definition. Regulation D simplifies private placement offerings by using bright-line tests. A more flexible approach could require market participants to perform additional evaluations to determine whether potential investors are eligible to participate in a particular offering. The increased complexity would result in multiple pools of accredited investors containing different types of persons. This could create uncertainty in accredited investor-only trading venues or increase compliance costs for issuers. Lastly, the variety of issuers, investor profiles, asset classes and risks involved in private offerings could make a scaled approach difficult to implement.

VI. Spouses and Spousal Equivalents

An individual, together with a spouse, may qualify as an accredited investor by surpassing the \$300,000 joint income threshold or the \$1 million joint net worth threshold. The Commission did not define the term “spouse” for purposes of calculating joint net worth when it originally adopted Regulation D²⁵⁹ or for purposes of calculating joint income when it added the concept of joint income to the accredited investor definition in 1988. Historically, issuers and investors have faced uncertainties about whether persons in legally recognized unions such as domestic partnerships, civil unions and same-sex marriages were considered spouses for purposes of the accredited investor definition. Because of these uncertainties, commenters and a rulemaking petition have urged the Commission to update the accredited investor definition to

²⁵⁹ The Commission originally proposed an individual net worth standard for the accredited investor definition. The joint net worth concept was incorporated into the final definition to simplify the net worth calculation. The Commission explained that limiting net worth to that of the individual investor presented potential issues for individuals in community property states and for individuals with assets held jointly with a spouse and that modifying the test to include joint net worth was a way to alleviate those potential issues. *See* Regulation D Adopting Release.

clarify that income and assets of both parties in same-sex unions may be included in the joint income and joint net worth calculations.²⁶⁰

Recent events have clarified some of these uncertainties. Prior federal law under the Defense of Marriage Act (“DOMA”)²⁶¹ provided that “[i]n determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word ‘marriage’ means only a legal union between one man and one woman as husband and wife, and the word ‘spouse’ refers only to a person of the opposite sex who is a husband or a wife.” In *U.S. v. Windsor*,²⁶² however, the United States Supreme Court held that this provision of DOMA “violates basic due process and equal protection principles applicable to the Federal Government” and that DOMA could not “survive under these principles.” Accordingly, the Commission clarified that, where they appear in the federal securities statutes administered by the Commission, the rules and regulations promulgated thereunder, releases, orders and any guidance issued by the Commission or the staff, the Commission will read the term “spouse” to include an individual married to a person of the same sex if the couple is lawfully married under state law, and the term “marriage” to include a marriage between individuals of the same sex if they are lawfully married under state law.²⁶³ At the time the Commission issued this guidance, a number of states did not permit same-sex

²⁶⁰ See rulemaking petition from Williams Mullen, File No. 4-665 (Sept. 16, 2013) (the “Williams Mullen Rulemaking Petition”); Maryland State Bar Letter; letters from StartupEquality.org (Sept. 4, 2013) (the “StartupEquality Letter”); Joe Wallin (Sept. 23, 2013).

²⁶¹ Pub. L. No. 104-199, 110 Stat. 2419 (1996).

²⁶² 133 S. Ct. 2675 (June 26, 2013).

²⁶³ Commission Guidance Regarding the Definition of the Terms “Spouse” and “Marriage” Following the Supreme Court’s Decision in *United States v. Windsor*, Release No. 33-9850 (June 19, 2015) [80 FR 37536].

marriages. In *Obergefell v. Hodges*,²⁶⁴ however, the United States Supreme Court recently held that “same-sex couples may exercise the fundamental right to marry in all States.” Therefore, the references to “spouse” in Rule 501 now include all individuals married to persons of the same sex.

Although recent Supreme Court decisions and Commission guidance have clarified any ambiguity with regard to same-sex marriages, issuers and investors may continue to face uncertainty regarding the treatment of legal unions other than marriage, same-sex or otherwise, such as domestic partnerships and civil unions. Under the current accredited investor definition, which refers to but does not define “spouse,” some couples may be unable to pool their financial resources for purposes of qualifying as accredited investors if they are not considered lawfully married under state law. To address the remaining uncertainty surrounding legal unions other than marriage, the Commission could add the following defined term to Rule 501 of Regulation D, as two commenters previously had requested:

A spouse of a natural person shall mean another person, regardless of gender or sexual orientation, whose relationship with the person specified: (1) may be characterized as such person’s (i) husband, (ii) wife, (iii) spouse, (iv) domestic partner, or (v) designated beneficiary under any applicable state law for the purpose of ensuring that each person in a two-person relationship has certain rights or financial protections based upon such designation; or (2) is that of the other party to a civil union with such person.²⁶⁵

Alternatively, the Commission could expand Rule 501(a) to permit “spousal equivalents” to pool their financial resources. In 2011, the Commission adopted a rule to define “family offices” excluded from the definition of “investment adviser” under the Advisers Act.²⁶⁶ The

²⁶⁴ 135 S. Ct. 2584 (June 26, 2015).

²⁶⁵ Williams Mullen Rulemaking Petition; StartupEquality Letter.

²⁶⁶ Family Offices, Release No. IA-3220 (June 22, 2011) [76 FR 37983] (the “Family Offices Release”).

Commission defined the term “family member” to include “spousal equivalents.”²⁶⁷ The term “spousal equivalent” means a cohabitant occupying a relationship generally equivalent to that of a spouse.²⁶⁸ Commenters generally supported the Commission’s inclusion of spousal equivalents.²⁶⁹ The Commission rule governing accountant independence also includes “spousal equivalents.”²⁷⁰

The Commission also considered this issue when adopting crowdfunding rules to implement the requirements of Title III of the JOBS Act. The JOBS Act provides that securities issued in reliance on the crowdfunding exemption may not be transferred by the purchaser for one year after the date of purchase, except when transferred to, among other persons, “a member of the family of the purchaser or the equivalent.”²⁷¹ The Commission included “spousal equivalent” in the definition of the term “member of the family of the purchaser or the equivalent” and the term “spousal equivalent” has the same definition as the definition used for family offices.²⁷²

Revising Rule 501(a) to permit “spousal equivalents” to pool their financial resources would maintain consistency with existing adopted and proposed Commission rules. In addition, the term “spousal equivalent” is sufficiently flexible to encompass future evolutions in federal or

²⁶⁷ 17 CFR 275.202(a)(11)(G)-1(d)(6).

²⁶⁸ 17 CFR 275.202(a)(11)(G)-1(d)(9).

²⁶⁹ *See* Family Offices Release. Two commenters opposed the inclusion of spousal equivalents. Those letters, however, invoked the restrictions contained in DOMA.

²⁷⁰ 17 CFR 210.2-01.

²⁷¹ 15 USC 77d-1(e)(1)(D); JOBS Act § 302(e)(1)(D).

²⁷² 17 CFR 227.501(c).

state law.

VII. Accredited Investor Entities

Section 413(b)(2)(A) of the Dodd-Frank Act directs the Commission to examine the accredited investor definition as applied to natural persons. This report also addresses the definition as applied to entities because requests for interpretive guidance²⁷³ and comment letters submitted in response to the 2007 Proposing Release suggest that revisions to the definition as applied to entities may be appropriate.

A. Current Framework

The accredited investor definition for entities relies on a list of enumerated categories found in the various subsections of Rule 501(a):

- *Rule 501(a)(1)*²⁷⁴ includes banks, savings and loan associations and similar institutions; registered broker-dealers; insurance companies; registered investment companies; licensed Small Business Investment Companies; state and political subdivision employee benefit plans with total assets in excess of \$5 million and certain employee benefit plans within the meaning of the Employee Retirement Income Security Act of 1974.²⁷⁵
- *Rule 501(a)(2)*²⁷⁶ includes private business development companies as defined in

²⁷³ See, e.g., Alaska Permanent Fund, SEC Division of Corporation Finance Interpretive Letter (July 14, 2011) (the “Alaska Permanent Fund Interpretive Letter”); Cardinal Financial Management Corporation, SEC Division of Corporation Finance Interpretive Letter (May 31, 1982) (the “Cardinal Financial Management Interpretive Letter”); Voluntary Hospitals of America, Incorporated, SEC Division of Corporation Finance Interpretive Letter (Dec. 30, 1982) (the “Voluntary Hospitals of America Interpretive Letter”); The Equitable Life Assurance Society of the United States, SEC Division of Corporation Finance Interpretive Letter (Feb. 1, 1986) (the “Equitable Life Assurance Society Interpretive Letter”); MIG Realty Advisors, Incorporated, SEC Division of Corporation Finance Interpretive Letter (Nov. 2, 1987) (the “MIG Realty Advisors Interpretive Letter”); Wolf, Block, Schorr and Solis-Cohen, SEC Division of Corporation Finance No-Action Letter (Dec. 11, 1996) (the “Wolf, Block No-Action Letter”).

²⁷⁴ 17 CFR 230.501(a)(1).

²⁷⁵ Pub. L. No. 93-406, 88 Stat. 829 (1974).

²⁷⁶ 17 CFR 230.501(a)(2).

Section 202(a)(22) of the Advisers Act.²⁷⁷

- *Rule 501(a)(3)*²⁷⁸ includes 501(c)(3)²⁷⁹ tax exempt nonprofit organizations, corporations, Massachusetts or similar business trusts and partnerships, in each case not formed for the specific purposes of acquiring the securities offered and with total assets in excess of \$5 million.
- *Rule 501(a)(7)*²⁸⁰ includes trusts with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered and whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii).²⁸¹
- *Rule 501(a)(8)*²⁸² includes entities in which all equity owners are themselves accredited investors.

Any entity not covered specifically by one of the enumerated categories is not an accredited investor under the rule. Entities not covered include limited liability companies, Indian tribes, other governmental entities and educational expense plans operated under Section 529 of the Internal Revenue Code (“529 Plans”).²⁸³ Not enumerating these and other legal entities in the definition has led to some degree of uncertainty as to whether they may qualify as accredited investors.²⁸⁴ In addition, state law developments since the adoption of Regulation D have expanded the types of business entities that exist and relatively recent concepts, such as low

²⁷⁷ 15 USC 80b-2(a)(22).

²⁷⁸ 17 CFR 230.501(a)(3).

²⁷⁹ 26 USC 501(c)(3).

²⁸⁰ 17 CFR 230.501(a)(7).

²⁸¹ 17 CFR 230.506(b)(2)(ii).

²⁸² 17 CFR 230.501(a)(8).

²⁸³ 26 USC 529.

²⁸⁴ *See* 2007 Proposing Release.

profit limited liability companies,²⁸⁵ suggest that developments in this area are ongoing.

In 2007, the Commission proposed amending the Rule 501(a)(3) list of entities to include “any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body or other legal entity with substantially similar legal attributes.”²⁸⁶ The Commission also proposed defining the term “governmental body” as it commonly appears in transactional financing documents.²⁸⁷ In proposing these changes, the Commission noted that it was attempting to reduce uncertainty and legal costs and promote more efficient private capital formation. Commenters generally supported the proposal to expand Rule 501(a)(3).²⁸⁸ Ultimately, the Commission did not adopt revisions to Rule 501(a)(3).

²⁸⁵ See, e.g., Wyo. Stat § 17-29-102(a)(ix).

²⁸⁶ 2007 Proposing Release.

²⁸⁷ The Commission proposed defining “governmental body” as any: (1) nation, state, county, town, village, district or other jurisdiction of any nature; (2) federal, state, local, municipal, foreign or other government; (3) governmental or quasi-governmental authority of any nature (including any governmental agency, branch, department, official or entity and any court or other tribunal); (4) multi-national organization or body; or (5) body exercising, or entitled to exercise, any administrative, executive, judicial, legislative, police, regulatory or taxing authority or power of any nature.

²⁸⁸ See, e.g., ABA Letter (supporting the proposal to expand Rule 501(a)(3) but also recommending using the term “any legal entity” without specifying any particular types of entities); Katten Muchin Letter (recommending a catch-all provision such as “any organized group of persons whether incorporated or not” and including “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act); Maryland State Bar Letter (supporting the proposal to expand Rule 501(a)(3) but also recommending including any “statutory business trust” instead of any “Massachusetts or similar business trust” and clarifying that investment funds sponsored by governmental entities and agencies thereof would be covered by the definition); 2007 MFA Letter (supporting the proposal to expand Rule 501(a)(3) but also recommending including “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act); 2007 NASAA Letter (not opposing the proposal to expand Rule 501(a)(3) if the minimum assets threshold was increased to \$10 million); letters from Native Capital Investment, Inc. (Oct. 8, 2007) (the “Native Capital Letter”) (supporting the proposal to expand Rule 501(a)(3)); SOAR Growth Capital, LLC (Oct. 9, 2007) (the “SOAR Letter”) (supporting the inclusion of Indian tribes); Arnold & Porter LLP (Feb. 24, 2010) (the “Arnold & Porter Letter”) (supporting the inclusion of sophisticated governmental bodies such as state governmental bodies); Davis Polk & Wardwell (Oct. 9, 2007) (supporting the proposal to expand Rule 501(a)(3) but also recommending including “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act).

B. Certain Entities Not Included in the Current Definition

Indian Tribes

The omission of Indian tribes from the accredited investor definition has limited their investment opportunities and created capital raising difficulties for tribal enterprises.²⁸⁹ In the 2007 Proposing Release, the Commission proposed expanding the accredited investor definition to specifically include Indian tribes. The Commission also solicited comments on whether the term “Indian tribe” should be defined and, if so, how. Specifically, the Commission asked if “Indian tribe” should be defined in terms of a tribe, band, nation, pueblo, village or community that the Secretary of the Interior acknowledges to exist as an Indian tribe under the Federally Recognized Indian Tribe List Act of 1994²⁹⁰ and if it should include state-recognized Indian tribes. Several commenters supported including Indian tribes in the accredited investor definition, either as specifically enumerated entities²⁹¹ or by expressly including them in the definition of “governmental body.”²⁹²

Other Governmental Entities

Several governmental and quasi-governmental entities have asked the Division of Corporation Finance for interpretive guidance about whether they may qualify as accredited

²⁸⁹ See, e.g., Gavin Clarkson, *Accredited Indians: Increasing the Flow of Private Equity into Indian Country as a Domestic Emerging Market*, 80 U. Colo. L. Rev. 285 (2009) (suggesting that the lack of tribal investment in Indian Country’s emerging economy due to tribes being excluded from the accredited investor definition creates some degree of hesitation among non-Indian investors);

²⁹⁰ Pub. L. 103-454, 108 Stat. 4791.

²⁹¹ See, e.g., Native Capital Letter; SOAR Letter.

²⁹² The 2007 Proposing Release proposed adding the term “governmental body” to the list of entities enumerated in Rule 501(a)(3) and some commenters suggested that it was appropriate to include Indian tribes in the definition of that term. See, e.g., letters from National Congress of American Indians (Jan. 2, 2008); Gavin Clarkson (Oct. 9, 2007).

investors under Rule 501(a).²⁹³ For example, in 2011, the Alaska Permanent Fund requested an interpretation that it is an accredited investor under Rule 501(a)(3).²⁹⁴ The Alaska Permanent Fund is a large sovereign wealth investment fund with a unique form of organization established by name in the constitution of the State of Alaska. The request noted that “[s]ome uncertainty exists as to the coverage of institutions substantially similar to those listed [in Rule 501(a)(3)]” and explained that “because the [Alaska Permanent] Fund has a unique constitutional statutory form and history it does not fit neatly with the more common forms of business trusts, corporations or partnerships that are the form commonly taken by private investment funds.” Based on the facts presented, the Division provided interpretive guidance indicating that, although the Alaska Permanent Fund is not organized as an entity specifically listed in Rule 501(a)(3), it may be treated as an accredited investor if it satisfies the other requirements of the definition.

In the 2007 Proposing Release, the Commission proposed expanding the accredited investor definition to specifically include government bodies. Several commenters supported including government bodies in the definition and provided recommendations about the approach.²⁹⁵ One commenter urged the Commission to exclude governmental entities from the

²⁹³ See, e.g., Alaska Permanent Fund Interpretive Letter; Cardinal Financial Management Interpretive Letter; Voluntary Hospitals of America Interpretive Letter; Equitable Life Assurance Society Interpretive Letter; MIG Realty Advisors Interpretive Letter.

²⁹⁴ Alaska Permanent Fund Interpretive Letter.

²⁹⁵ See, e.g., ABA Letter (recommending a principles-based approach to describing governmental bodies, rather than providing a detailed definition); Arnold & Porter Letter (supporting the inclusion of governmental bodies as proposed); Maryland State Bar Letter (recommending clarifying that investment funds sponsored by governmental entities and agencies thereof would be covered by the definition); letters from Keith Paul Bishop (Oct. 11, 2007) (the Bishop Letter) (recommending that any assets or investments threshold not apply to governmental entities); National Association of Independent Public Finance Advisors (Mar. 10, 2008) (recommending a threshold of \$5 million of investments under direct active management).

definition because of the involvement of some governmental entities in troubled investments.²⁹⁶

In light of the impact troubled investments can have on governmental entities, their constituents and their states, any expansion of the accredited investor definition to include governmental entities requires careful consideration of an entity's financial sophistication and ability to fend for itself. For example, expanding Rule 501(a)(3) to include any governmental entity could result in entities with \$5 million in non-financial assets, such as land, buildings and vehicles, qualifying as accredited investors even if they have no investment experience. An asset-based test likely would not serve as a reliable method for ascertaining whether a governmental entity is likely to have sufficient knowledge in financial and business matters to evaluate the merits and risks of prospective investments without the protections of registration. An investments-based test, however, could reflect meaningful investing experience and exposure to financial markets.

Limited Liability Companies and Newer Categories of Business Entities

While limited liability companies are a familiar part of the business landscape, only two states had limited liability company statutes when the Commission adopted Regulation D.²⁹⁷ Because of the static nature of the accredited investor definition, market participants have sought interpretive relief from the staff to adapt to state law developments. Commission staff provided relief in the case of limited liability companies, stating that a limited liability company may be treated as an accredited investor as defined in Rule 501(a)(3) if it satisfied the other requirements

²⁹⁶ See Melton Letter.

²⁹⁷ In 1982, only Wyoming and Florida had limited liability company statutes. See William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. Colo. L. Rev. 855 (1995).

of the definition.²⁹⁸ In 2007, the Commission proposed to include limited liability companies in the list of legal entities included in Rule 501(a)(3).²⁹⁹ Commenters generally supported expanding the categories of entities qualifying as accredited investors, but one noted that the proposed approach of enumerating specified entities would not allow for future developments.³⁰⁰

Business Trusts

Rule 501(a)(3) includes Massachusetts or similar business trusts within the scope of entities that may qualify as accredited investors.³⁰¹ One commenter on the 2007 Proposing Release indicated that referencing a specific type of business trust under one state's business code was unnecessarily limiting and confusing.³⁰² This potential confusion is indicative of the overall limitations inherent in attempting to enumerate all qualifying entities within a list.

529 Educational Savings Plans

529 Plans are not specifically enumerated in the accredited investor definition.³⁰³ To the extent these plans meet the financial criteria applicable to other entities, there is no apparent regulatory rationale for excluding them. It appears more appropriate to focus on whether the corresponding financial criteria accurately serve as proxies for financial sophistication or ability to fend for oneself instead of on how entities are organized or treated for taxation purposes.

²⁹⁸ Wolf, Block No-Action Letter; Securities Act Rules Compliance and Disclosure Interpretation 255.05.

²⁹⁹ 2007 Proposing Release.

³⁰⁰ See ABA Letter.

³⁰¹ Trusts may also qualify as accredited investors directly under subparagraph (a)(7) and indirectly under subparagraphs (a)(1) and (a)(8). See Regulation D Interpretive Release.

³⁰² See Maryland State Bar Letter.

³⁰³ A 529 Plan may qualify under Rule 501(a)(3) if it is organized as a corporation or under Rule 501(a)(8) if it is organized as a trust.

Non-501(c)(3) Tax Exempt Nonprofit Organizations

Internal Revenue Code Section 501(c)(3) tax exempt nonprofit organizations are included in the accredited investor definition but other tax exempt nonprofit organizations are not. Examples of tax exempt nonprofit organizations that do not qualify as accredited investors include civic leagues, labor organizations, business leagues, chambers of commerce and voluntary employees' beneficiary associations.³⁰⁴ In response to requests for interpretive guidance, the staff has indicated that a federal income tax exempt governmental unit meeting the substantive criteria of Section 501(c)(3) with total assets in excess of \$5,000,000 may be deemed a Section 501(c)(3) organization for purposes of qualifying as an accredited investor.³⁰⁵ In contrast, the staff has indicated that tax exempt organizations not substantially meeting the requirements of Section 501(c)(3) will not be deemed to constitute accredited investors.³⁰⁶

C. Alternative Frameworks

The principal limitations with the current accredited investor framework for entities are that some types of entities are not accredited investors because the definition does not specifically include them, and that the definition does not provide flexibility for legal developments. As a result, entities not specifically included must request clarification through interpretive guidance, which increases legal costs and creates transactional uncertainties.

Rule 501(a)(3) originated as a narrow provision with limited applicability and has

³⁰⁴ These organizations may qualify under Rule 501(a)(3) if they are organized as corporations or under Rule 501(a)(8) if they are organized as trusts.

³⁰⁵ *See, e.g.*, Voluntary Hospitals of America Interpretive Letter; Equitable Life Assurance Society Interpretive Letter.

³⁰⁶ *See, e.g.*, C.U. Brokerage Services, Inc., SEC Division of Corporation Finance Interpretive Letter (Mar. 5, 1985).

evolved over time into a common way for entities to qualify as accredited investors.³⁰⁷ If the accredited investor definition continues to apply to only specific enumerated entities instead of all types of entities, revisions may be required periodically in response to legal and economic developments. In the 2007 Proposing Release, the Commission asked whether it should delete the list entirely and simply say that any legal entity that can sue or be sued in the United States can qualify as an accredited investor, provided it meets the other standards for becoming an accredited investor. Commenters generally supported a catch-all provision.³⁰⁸

Making the definition applicable to all types of entities, however, could result in entities without access to sufficient information and lacking the financial sophistication needed to conduct meaningful investment analysis becoming accredited investors. Expanding the definition in that manner would require careful consideration of whether the existing asset-based test identifies those entities that do not need the protections of registration.

In the 2007 Proposing Release, the Commission proposed adding an alternative investments-owned standard to the accredited investor definition that would have allowed entities with investments in excess of \$5 million to qualify as accredited investors. The Commission indicated that an investments-owned standard would add a potentially more accurate method to assess an investor's need for the protections of registration under the Securities Act. An investments-owned standard may be a more effective proxy for financial

³⁰⁷ As originally proposed, Rule 501(a)(3) included only college and university endowment funds with assets in excess of \$25 million. Regulation D Proposing Release. Based on comments received, the Commission expanded the provision to include all organizations described as exempt organizations in Section 501(c)(3) of the Internal Revenue Code. In tandem, the Commission lowered the asset threshold to \$5 million. Regulation D Adopting Release. In 1988, the Commission further expanded Rule 501(a)(3) to include corporations, Massachusetts or similar business trusts and partnerships that met the \$5 million asset threshold. Regulation D Revisions Adopting Release.

³⁰⁸ See, e.g., ABA Letter; Katten Muchin Letter; Bishop Letter.

sophistication than an asset-based test, as it reflects exposure to investment markets. The Commission also indicated that an investments-owned standard might reduce and simplify compliance burdens for companies by providing an alternative standard that may be assessed more easily than the assets standard. The Commission received support for including this alternative standard.³⁰⁹ Commenters generally preferred a principles-based definition of the term “investments” rather than the proposed definition, which was based on Investment Company Act Rule 2a51-1(b).³¹⁰

A revised accredited investor definition for entities that includes a catch-all provision and an investments-owned test may more effectively measure financial sophistication than the current definition, which focuses on an entity’s form of organization and its assets, which may include illiquid and non-investment assets. As noted in the 2007 NASAA Letter, “[the revisions included in the 2007 Proposing Release] will eliminate arbitrary distinctions based on the organizational types of various entities, where there is no correlation between the form of entity and the need for the protections of securities registration.” Instead, NASAA recommended that the Commission ensure that the entities have the financial qualifications to protect themselves in a securities transaction.³¹¹

VIII. Implications Outside of the Regulation D Context

In addition to being a historical cornerstone of Regulation D, the accredited investor definition is used in other federal and state securities law provisions and has taken on increased

³⁰⁹ See, e.g., ABA Letter; Massachusetts Securities Division Letter.

³¹⁰ See, e.g., ABA Letter; Maryland State Bar Letter; NVCA Letter; letter from Price Meadows Incorporated (Oct. 5, 2007).

³¹¹ The 2007 NASAA Letter also suggested increasing the minimum assets from \$5 million to \$10 million.

significance as a result of the JOBS Act. For example, the JOBS Act and the proposed and adopted rules thereunder use the definition for the following purposes:

- Section 501 of the JOBS Act increased the holders of record threshold for purposes of registration under Section 12(g) of the Exchange Act³¹² for issuers that are neither banks nor bank holding companies to either 2,000 persons or 500 persons who are not accredited investors. As a result, issuers seeking to rely on the increased thresholds will need to differentiate between record holders who are accredited investors and non-accredited investors. The Commission has proposed that the accredited investor definition in Rule 501(a) apply in making those determinations.³¹³
- Section 401 of the JOBS Act required the Commission to amend Regulation A to exempt offerings of up to \$50 million of securities annually from the registration requirements of the Securities Act. Amended Regulation A limits the amount of securities non-accredited investors can purchase in certain of those offerings to no more than 10% of the greater of their annual income or their net worth.³¹⁴ Accredited investors are not subject to investment limitations.
- Section 201(a) of the JOBS Act required the Commission to revise Rule 506 to permit general solicitation in private offerings, provided that all purchasers are accredited investors and the issuer takes reasonable steps to verify such accreditation. The Commission revised Rule 506 in July 2013.³¹⁵

Some states use the accredited investor definition to determine whether investment advisers to certain private funds are required to be registered.³¹⁶ States also incorporate the definition in a variety of other contexts. For example, the definition is used in government

³¹² 15 USC 78l(g).

³¹³ Changes to Exchange Act Registration Requirements To Implement Title V and Title VI of the JOBS Act, Release No. 33-9693 (Dec. 18, 2014) [79 FR 78343].

³¹⁴ 17 CFR 230.251(d)(2)(i)(C).

³¹⁵ Rule 506(c) Adopting Release.

³¹⁶ *See, e.g.*, Final Order Granting Exemption From the Registration Requirements for Investment Advisers to Private Funds and Their Investment Adviser Representatives, Wisconsin Department of Financial Institutions, Division of Securities (Feb. 17, 2012); Certificate Exemption for Investment Advisers to Private Funds, Cal. Code Regs. Title 10 § 260.204.9; Sixth Transition Order administering the Michigan Uniform Securities Act, State of Michigan Department of Energy, Labor & Economic Growth, Office of Financial and Insurance Regulation (Mar. 11, 2011).

finance,³¹⁷ finance lending,³¹⁸ mortgage lending,³¹⁹ insurance³²⁰ and financial institution regulation.³²¹ The accredited investor definition also served as a model for an exemption under the Uniform Securities Act of 2002.³²²

FINRA also uses the accredited investor definition to provide an exemption from the general requirement that each member firm that sells an issuer's securities in a private placement file with FINRA a copy of any private placement memorandum, term sheet or other offering document the firm used within 15 calendar days of the date of the sale, or indicate that it did not use any such offering documents.³²³ FINRA Rule 5123 contains an exemption for offerings sold to, among other persons, accredited investors described in Securities Act Rule 501(a)(1), (2), (3) or (7). The rule does not incorporate the entire accredited investor definition, and in particular excludes the net worth and income criteria set forth in Rule 501(a)(5) and (6) respectively. The Commission release approving FINRA's adoption of this rule noted the following rationale:

Several commenters requested additional exemptions from coverage under Rule 5123. [One commenter], for example, requested an exemption for all accredited investors. FINRA stated that it does not believe that the exemption should extend to offers to accredited investors under Rule 501(a)(4), (5), or (6) of Regulation D. In particular, FINRA stated that it believes that the criteria used to measure whether a person meets the accredited investor standard do not necessarily reflect a sufficiently high level of sophistication to justify exemption from the proposed rule.³²⁴

³¹⁷ See, e.g., Cal. Gov't Code § 64111.

³¹⁸ See, e.g., Cal. Fin. Code § 22064.

³¹⁹ See, e.g., Fla. Stat. §§ 494.001 and 494.00115.

³²⁰ See, e.g., Tex. Ins. Code § 1111A.002.

³²¹ See, e.g., Conn. Gen. Stat. § 36a-2 (2014); N.H. Rev. Stat. §§ 392-A:1 and 392-A:3.

³²² Uniform Securities Act of 2002 §§ 102(11)(F) through 102(11)(K), 102(11)(O) and 202(13).

³²³ FINRA Rule 5123(b)(1)(J).

³²⁴ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of

Due to the widespread use of the accredited investor definition, changes to the definition would have significant direct and indirect impacts in a variety of contexts.

IX. Recommendations

Registration under the federal securities laws is intended to help ensure the adequate provision of relevant information about an issuer and its offering of securities so that investors can make informed investment decisions. Exemptions from registration are provided for situations where there is no practical need for registration or the public benefits from registration are too remote. The accredited investor concept in Regulation D was designed to identify, with bright-line standards, a category of investors whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of registration unnecessary.

The Regulation D market has become a large and vibrant market for raising capital, especially for small business capital formation.³²⁵ The Unregistered Offerings White Paper data shows that Regulation D offerings occur with far greater frequency than any other offering markets surveyed. As accredited investors play a critical role in providing capital for this market, any change to the accredited investor definition would have to consider both the impact the change could have on investors and the supply of capital to the Regulation D market.

There is a tradeoff between using a principles-based accredited investor definition and the

Amendments No. 2 and No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendments No. 1, No. 2, and No. 3 to Adopt FINRA Rule 5123 (Private Placements of Securities) in the Consolidated FINRA Rulebook, Release No. 34-67157 (June 7, 2012) [77 FR 35457].

³²⁵ The aggregate amount of capital raised through Regulation D offerings is large, but a significantly lower median offering size indicates a large number of small offerings, consistent with the original regulatory objective to target the capital formation needs of small businesses. *See* Unregistered Offerings White Paper.

need for bright-line standards that investors, issuers and their advisors can understand and apply easily. Uncertainty surrounded private placements and small business offerings during the principles-based regulatory regime that was in place prior to the adoption of Regulation D. Bright-line standards, however, are necessarily under- and over-inclusive. For example, the fact that an individual has a high net worth does not necessarily mean the individual is financially sophisticated, while a personal finance expert without requisite levels of income or net worth is not an accredited investor under the current definition. The staff believes that the Commission should consider any one or more of the following methods of revising the accredited investor definition.

1. The Commission Should Revise the Financial Thresholds Requirements for Natural Persons to Qualify as Accredited Investors and the List-Based Approach for Entities to Qualify as Accredited Investors.

Regulation D uses income and net worth thresholds to identify natural persons as accredited investors. The Commission established the \$200,000 individual income and \$1 million net worth thresholds in 1982 and the \$300,000 joint income threshold in 1988. Since then, the number of U.S. households qualifying as accredited investors has increased from approximately 2% of the population to over 10% as a result of inflation. While the size of the accredited investor pool has increased significantly, the staff is not aware of evidence suggesting that individuals qualifying as accredited investors under the current financial thresholds and participating in the Regulation D market require the protections of registration. On the other hand, inflation has increased the likelihood that the current pool of accredited investors may contain individuals the definition did not originally intend to encompass.

Regulation D uses enumerated categories to identify entities as accredited investors. Some types of entities qualify as accredited investors with over \$5 million in assets, while other

types of entities qualify as accredited investors without being subject to the asset test. Any type of entity not covered specifically by one of the enumerated categories is not an accredited investor. The approach of specifically enumerating types of entities has resulted in the exclusion of some entities that likely should be accredited investors.

The staff believes that the following approaches could address concerns with how the current definition identifies accredited investor natural persons and entities.

A. Leave the Current Income and Net Worth Thresholds in Place, Subject to Investment Limitations.

Inflation has expanded significantly the number of individuals who qualify as accredited investors based on income and net worth. Limiting investment amounts for individuals who qualify as accredited investors based solely on the current income or net worth thresholds could provide protections for those individuals who are less able to bear financial losses. In addition, leaving the current thresholds in place, instead of simply increasing them to reflect inflation, would not diminish the size of the accredited investor pool and would provide a mechanism for individuals to continue to invest in private offerings. The Commission could consider leaving the current income and net worth thresholds in the accredited investor definition in place, but limiting investments for individuals who qualify as accredited investors solely based on those thresholds to a percentage of their income or net worth (e.g., 10% of prior year income or 10% of net worth, as applicable, per issuer, in any 12-month period).

B. Add New Inflation-Adjusted Income and Net Worth Thresholds that Are Not Subject to Investment Limitations.

The income and net worth thresholds have never been adjusted, although inflation has eroded them considerably. The \$200,000 individual income threshold established in 1982 represents approximately \$433,000 to \$491,000 in today's dollars and the \$300,000 joint income

threshold established in 1988 represents approximately \$529,000 to \$601,000 in today's dollars. The \$1 million net worth threshold established in 1982 represents approximately \$2.16 million to \$2.45 million in today's dollars. While many commenters oppose increasing the financial thresholds in the definition, others support such an adjustment. The staff believes that the financial thresholds should be adjusted to reflect inflation to be consistent with the Commission's 1982 and 1988 policy choices. The staff also believes that the potential alternative criteria identified below could provide adequate avenues for sophisticated individuals to qualify as accredited investors. The Commission could consider adding new inflation-adjusted income and net worth thresholds. Thresholds such as \$500,000 for individual income, \$750,000 for joint income and \$2.5 million for net worth would reflect inflation and maintain the ratios in the current definition. Under this approach, individuals who meet the new income or net worth thresholds would not be subject to the investment limitations suggested in paragraph A above.

C. Index All Financial Thresholds in the Definition for Inflation on a Going-Forward Basis.

Indexing the financial thresholds in the accredited investor definition for inflation would be consistent with the Commission's approach in its 2007 proposed revisions to the definition, as well as the approach Congress took in the Dodd-Frank Act with respect to the "qualified client" definition and in the JOBS Act with respect to crowdfunding and emerging growth companies. Section 413(b)(2)(A) of the Dodd-Frank Act requires the Commission to undertake a review of the accredited investor definition at least once every four years. The Commission could consider indexing all financial thresholds in the accredited investor definition for inflation, rounded to the nearest \$10,000, on a going-forward basis every four years to coincide with the Commission reviews.

D. Permit Spousal Equivalents to Pool their Finances for the Purpose of Qualifying as Accredited Investors.

When first adopted, the accredited investor definition attempted to simplify financial calculations for investors living in community property states or where property was held jointly by providing for qualification based on joint net worth. Allowing spousal equivalents to pool their finances would provide consistent regulatory treatment among marriages, civil unions and domestic partnerships.

The Commission could consider adding the term “spousal equivalent” to the accredited investor definition. To promote consistency across Commission rules, the term could be defined as “a cohabitant occupying a relationship generally equivalent to that of a spouse,” which is the same definition as used in the family office rule, accountant independence standards and crowdfunding rules.

E. Permit All Entities With Investments In Excess of \$5 Million to Qualify as Accredited Investors.

The accredited investor definition does not provide a mechanism for limited liability companies and certain other business entities, Indian tribes, labor unions, social enterprises, sovereign wealth funds, 529 Plans, and any other entities not specifically listed in the definition to qualify as accredited investors. Limiting the exemption to specific entities has resulted in regulatory uncertainty and may not effectively serve the rule’s investor protection objectives. The Commission could consider modifying the definition to permit any entity with investments in excess of \$5 million, and not formed for the specific purpose of investing in the securities offered, to qualify as an accredited investor.

The Commission also could consider replacing the assets test in the current definition with an investments test because the staff believes it would provide a more meaningful standard

for ascertaining whether an entity is likely to have sufficient knowledge in financial and business matters to enable it to evaluate the merits and risks of potential investments without the protections of registration. An “investments” definition based on the definition of investments in Rule 2a51-1(b) would promote consistency across securities laws and provide a predictable framework.

The Commission could consider retaining the current provisions that permit certain regulated entities (e.g., banks, savings and loan associations, insurance companies) to qualify as accredited investors without any financial thresholds.

F. Permit an Issuer’s Investors That Meet and Continue to Meet the Current Accredited Investor Definition to Be Grandfathered with Respect to Future Offerings of the Issuer’s Securities.

If the Commission modifies the accredited investor definition, the Commission also should consider grandfathering issuers’ current investors who meet and continue to meet the current accredited investor standards with respect to future offerings of the same issuers’ securities. Grandfathering would provide protection from investment dilution for any person who would no longer be accredited investors because of any changes to the definition. The grandfathering provision could apply to future investments in a particular issuer only, and not to future investments in affiliates of the issuer.

2. The Commission Should Revise the Accredited Investor Definition to Allow Individuals to Qualify as Accredited Investors Based on Other Measures of Sophistication.

The existing accredited investor definition as applied to natural persons uses only financial measures to serve as a proxy for financial sophistication and ability to sustain investment losses or fend for one’s self. It is not likely, however, that any single criteria – including the existing income and net worth standards – can determine that an individual will possess those attributes. The staff believes that it is reasonable to view an investor’s financial

sophistication, on the one hand, and ability to absorb losses, on the other, as providing different ways to assess accredited investor status. For example, very well informed investors who are not wealthy may be in a position to take on risks that they understand well, while very wealthy investors may be in a position to take on risks even if they lack financial sophistication.

The staff believes that the following approaches could be considered to identify individuals who could qualify as accredited investors based on criteria other than income and net worth.

A. Permit Individuals With a Minimum Amount of Investments to Qualify as Accredited Investors.

Investments may in some cases be a more meaningful measure of individuals' experience with and exposure to the financial and investing markets than income or net worth. Commenters and market participants have expressed support for the accredited investor definition to include an investments test, although they have different views about how to establish such a test. An "investments" definition based on the definition of investments in Rule 2a51-1(b) would promote consistency across securities laws and provide a predictable framework. The Commission could consider adding an investments test to the accredited investor definition so that individuals with a minimum amount of investments, as that term is defined in Rule 2a51-1(b), qualify as accredited investors.³²⁶

B. Permit Individuals With Certain Professional Credentials to Qualify as Accredited Investors.

Expanding the accredited investor definition to include persons holding certain professional credentials would recognize an objective indication of sophistication. The

³²⁶ In 2007 the Commission proposed applying a \$750,000 minimum investment threshold. *See* 2007 Proposing Release.

Commission could consider adding a new category to the accredited investor definition that, for example, includes individuals who have passed the Series 7 examination, Series 65 examination or Series 82 examination. Those credentials may provide demonstrable evidence of relevant investor sophistication because of the subject matter their examinations cover.

C. Permit Individuals With Experience Investing in Exempt Offerings to Qualify as Accredited Investors.

Expanding the accredited investor definition to include individuals with relevant investment experience would recognize an objective indication of financial sophistication and allow experienced investors to maintain their accredited investor status. These individuals presumably have developed knowledge about the private capital markets, including their inherent risks. This experience may include performing due diligence, negotiating investment terms and making valuation determinations. As previously noted, on average, current angel investors appear to have invested in ten prior offerings. The Commission could consider adding a new category to the accredited investor definition that includes individuals who have invested in at least ten private securities offerings, each conducted by a different issuer, under Securities Act Section 4(a)(2), the safe harbor promulgated thereunder, or Rule 506(c). This limitation would focus the criteria on recognizing only relevant investment experience.

D. Permit Knowledgeable Employees of Private Funds to Qualify as Accredited Investors for Investments in their Employer's Funds.

A private fund's knowledgeable employees likely have significant investing experience and sufficient access to the information necessary to make informed decisions about investments in their employer's funds. Expanding the accredited investor definition to include knowledgeable employees of private funds would recognize this specific category of individuals as capable of fending for themselves. The Commission could consider adding a new category to

the accredited investor definition that includes “knowledgeable employees” of “covered companies” as those terms are defined in Rule 3c-5 of the Investment Company Act.

E. Permit Individuals Who Pass an Accredited Investor Examination to Qualify as Accredited Investors.

Creating an accredited investor examination could provide a path for individuals who can objectively demonstrate they are financially sophisticated and understand the nature and risks of unregistered offerings to qualify as accredited investors. This approach could enable financially sophisticated individuals to qualify as accredited investors regardless of their wealth, educational background or professional experience. An accredited investor examination may reduce compliance burdens on issuers, since verification of a passing score on an examination would typically not require significant time or cost. The staff believes that any such accredited investor examination would need to test financial and investing knowledge, as well as understanding of private offerings and the risks involved with them. Portions of FINRA’s Series 7 and Series 82 examinations cover these areas and could potentially serve as a model for an accredited investor examination. The Commission could explore the possibility of developing an accredited investor examination. If development of an accredited examination is feasible, the Commission could consider revising the accredited investor definition to provide that individuals who pass the examination qualify as accredited investors.

X. Impact of the Potential Approaches on the Pool of Accredited Investors

Revising the standards for qualifying as an accredited investor would alter the size and composition of the pool of accredited investors that are natural persons. In this section, the staff presents estimates for the number of U.S. households that would qualify as accredited investors under the potential criteria.³²⁷ We also provide broad profiles of the pools of investors that meet the current and potential criteria based on various demographic characteristics. Where the potential criteria are not easily quantifiable, we qualitatively evaluate their impact on the accredited investor pool.

The underlying household data for this analysis was obtained from the Federal Reserve Board's Survey of Consumer Finances (the "SCF") for 1983 and 2013.³²⁸ The SCF is a triennial survey that provides insights into household income and net worth, where the household is considered to be the primary economic unit within a family. While the SCF collects information on families' total income before taxes for the preceding calendar year, the bulk of the data, including family balance sheet data and demographic characteristics, covers the status of the family at the time of the interview.³²⁹ The SCF employs weights to make the data representative of the U.S. population.³³⁰ Thus, the 1983 SCF and the 2013 SCF are representative of the U.S.

³²⁷ We estimate households and not individuals due to data limitations; the database underlying our analysis measures wealth and income at the household level.

³²⁸ <http://www.federalreserve.gov/econresdata/scf/scfindex.htm>.

³²⁹ A major feature of the database is that missing data is imputed by repeatedly drawing an estimate from the conditional distribution of the data. This is done five times and the imputations are recorded as five replicates for each household. As replicate weights are calculated only for the first implicate for each household, we use only the first implicate in our analysis. Nevertheless, we compared the estimates provided below with estimates using all five implicates. We do not find any statistically significant differences between the two sets of estimates.

³³⁰ See Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Kevin B. Moore, John Sabelhaus, Jeffrey Thompson and Richard A. Windle, *Changes in U.S. Family Finances from 2010 to 2013: Evidence*

population in 1983 (approximately 83.9 million households) and 2013 (approximately 122.5 million households), respectively.

For the analysis, we use variables as defined by Bricker, *et al.* 2014.³³¹ We provide descriptions of the main variables below. Data for inflation was obtained from the CPI indices database of the Bureau of Labor Statistics and the PCE indices database of the Bureau of Economic Analysis, United States Department of Commerce.

- *Income* – Includes wage income, business income, rent income, interest and dividend income, pension income, social security income, income from retirement accounts, transfers and other income. According to the SCF documentation, income data is collected for the year prior to the year of the SCF.³³² As suggested by Bricker, *et al.* 2014, we adjust the income data by a factor of 1.0145 to reflect 2013 dollars so that it is comparable to the data for net worth and other variables. We further adjust the data by a factor of 1.0162 to account for inflation for the period 2013-2014 and to reflect the value in 2014 dollars.

It should be noted that in the SCF database income is reported at the household level. We do not attempt to differentiate income based on marital status of the household³³³ because data on individual income from all sources is not available, at least in the public version of the database.³³⁴ As a result, accredited investor (household) estimates based on individual income thresholds are likely to be overestimated and would represent upper bounds.

A household can have multiple family members with independent sources of income that qualify them as accredited investors based on income. We count them as one accredited investor for each household, which implies we are also likely underestimating the actual pool of accredited investors when we provide household

from the Survey of Consumer Finances, Federal Reserve Bulletin, Vol. 100, No. 4 (2014) (“Bricker, et al. 2014”). The dollar amounts are adjusted to 2013 dollars using the ‘current methods’ version of the CPI.

³³¹ *Id.* See also <http://www.federalreserve.gov/econresdata/scf/files/bulletin.macro.txt>.

³³² *Id.*

³³³ We find that three-fifths of the households that qualify on individual income basis have spouses that are self-employed or are employed by someone else.

³³⁴ Individual wage income at the time of survey (not the previous year as with total income data) is available, but it is an incomplete representation. For example, individual income of self-employed household members, or investment income of individuals in the household is not available.

estimates. Consequently, the household estimates we derive utilizing the joint income threshold would represent a lower bound for individuals qualifying on the basis of income.

The actual number of individuals that qualify as accredited investors on income basis (individual or joint) would, in all likelihood, lie between the estimates that we derive for the individual income threshold and the joint income threshold.

- *Net Worth* – This measure represents the difference between household assets and household debt. Assets include all financial and non-financial assets.³³⁵ Debt includes mortgage and home equity loans, lines of credit, credit card debt, installment loans including vehicle loans, margin loans, pension loans and other debt (*e.g.*, loans against insurance). We exclude the value of the household’s principal residence and any outstanding mortgages associated with the principal residence. We also adjust the net worth figure by a factor of 1.0162 to reflect 2014 dollars.
- *Investments* – We calculate investments, for the purpose of defining “minimum investments,” based on Investment Company Act Rule 2a51-1. Investments thus includes:
 - All financial assets
 - Non-financial assets - real estate (excluding primary residence) and other non-financial assets (including commodities, antiques, stamp collections, oil/gas/mineral leases, etc.)

A. Impact of Potential Approaches

1. New Income Threshold of \$500,000 and Net Worth Threshold of \$2.5 Million That Reflect Inflation and Are Not Subject to Investment Limitations

Increasing the individual income threshold from \$200,000 to \$500,000 and the net worth threshold from \$1 million to \$2.5 million to reflect the impact of inflation since 1982 would shrink considerably the number of households that qualify as accredited investors, without any investment limitations, on the basis of income or net worth. As Table 10.1 below shows, the number of households that would qualify under the new thresholds is approximately 28% of the

³³⁵ Financial assets include all stocks, bonds, mutual funds, cash, and cash management accounts, retirement assets, life insurance, managed assets like trusts and annuities, and other financial assets like deferred compensation, royalties, futures etc.

households that currently qualify under the individual or joint income standards. Similarly, as Table 10.2 below shows, the number of households that would qualify under the \$2.5 million net worth standard is approximately 40% of the households that currently qualify under the \$1 million standard.

Table 10.1: Number and Percentage of Households Qualifying Under Alternate Individual and Joint Income Criteria

| | Individual Income Threshold | Households Qualifying, in Millions, and Percentage of all U.S. Households | | Joint Income Threshold | Households Qualifying, in Millions, and Percentage of all U.S. Households | |
|--|-----------------------------|---|------|------------------------|---|------|
| Current Standard: 1983 SCF | \$200,000 | 0.44 (0.04) | 0.5% | | | |
| Current Standard: 2013 SCF | \$200,000 | 8.07 (0.39) | 6.6% | \$300,000 | 4.04 (0.25) | 3.3% |
| Current Standard - Inflation Adjusted (CPI): 2013 SCF | \$490,819 | 2.11 (0.17) | 1.7% | \$600,558 | 1.60 (0.14) | 1.3% |
| Current Standard – Inflation Adjusted (PCE): 2013 SCF | \$432,265 | 2.41 (0.18) | 2.0% | \$528,906 | 1.95 (0.16) | 1.6% |
| Recommended Threshold: 2013 SCF | \$500,000 | 2.09 (0.17) | 1.7% | \$750,000 | 1.14 (0.11) | 0.9% |

Figures in parentheses are standard errors, in millions of households.³³⁶

³³⁶ The SCF database uses sampling to estimate population characteristics. The standard error of the mean measures the accuracy with which the sample represents the population. It enables us to calculate the range within which the true (population) estimate of the sample mean is likely to be. Statistically (assuming certain distributional characteristics), the population estimate would be within one standard of the mean at least 68% of the time and within two standard errors of the mean at least 95% of the time. For example, the number of households that currently qualify as accredited investors on the basis of individual income is estimated (using 2013 SCF data) to be 8.07 million households. The standard error of 0.39 million households indicates that we can have 95% confidence that the actual number of accredited investor households are between 7.31 million households and 8.83 million households (*i.e.*, $8.07 - 1.96 * 0.39$, $8.07 + 1.96 * 0.39$).

Table 10.2: Number and Percentage of Households Qualifying Under Alternate Net Worth Criteria

| | Net Worth Threshold | Households Qualifying, in Millions, and Percentage of all U.S. Households | |
|--|----------------------------|--|------|
| Current Criteria: 1983 SCF | \$1,000,000 | 1.42 (0.14) | 1.7% |
| Current Criteria: 2013 SCF | \$1,000,000 | 9.22 (0.40) | 7.5% |
| Current Criteria - Inflation Adjusted (CPI): 2013 SCF | \$2,454,093 | 3.86 (0.22) | 3.1% |
| Current Criteria – Inflation Adjusted (PCE): 2013 SCF | \$2,161,326 | 4.49 (0.24) | 3.7% |
| Recommended Criteria: 2013 SCF | \$2,500,000 | 3.84 (0.22) | 3.1% |

Figures in parentheses are standard errors, in millions of households.

2. Current Income and Net Worth Thresholds, Subject to Investment Limitations

Conditional qualification³³⁷ of households that have individual income between \$200,000 and \$500,000, joint income between \$300,000 and \$750,000, or net worth between \$ 1 million and \$2.5 million would ensure that all the households that currently qualify as accredited investors on the basis of income or net worth continue to be qualified to participate in Regulation D offerings as accredited investors. At the same time, an investment limitation per offering, while maintaining the number of accredited investors, could decrease the supply of capital that is available for investment in Regulation D offerings.

³³⁷ As used in this section, the term “conditional qualification” means limiting the investment amounts for these individuals to a percentage of their income or net worth (*e.g.*, 10% of prior year income or 10% of net worth, as applicable, per issuer, in any 12-month period).

Table 10.3: Number and Percentage of Households Qualifying, on a Conditional Basis

| | Qualifying Households, in Millions, and Percentage of all U.S. Households 2013 SCF | | | |
|--|---|------|-----------------|------|
| | CPI | | PCE | |
| Individual Income between \$200,000 and \$500,000 Or Joint Income between \$300,000 and \$750,000 | 5.99 (0.36) | 4.9% | 5.94% (0.36) | 4.8% |
| Household Net Worth between \$1,000,000 and \$2,500,000 | 5.38 (0.34) | 4.4% | 5.35 (0.34) | 4.4% |

Figures in parentheses are standard errors, in millions of households.

3. Permit Individuals With a Minimum Amount of Investments to Qualify as Accredited Investors.

Adding a new minimum investments criteria would increase the number of households that qualify as accredited investors. The net increase to the accredited investor pool would be attributed to any households that do not currently qualify as accredited investors but would qualify under the new minimum investments criteria.

We find a large overlap between households that qualify under current standards and those that would qualify under a new minimum investments criteria. Table 10.4 below presents the proportion of the U.S. household population that would qualify under different minimum investments thresholds and the net impact the new criteria would have on the current accredited investor pool. We also present, in the last column, the net impact a minimum investments criteria would have on the number of households that would not be limited in their investment amounts. The additional households would be those that qualify under the conditional income and net worth thresholds outlined in Tables 1 and 2 above whose investments would not be

limited because they also qualify under the minimum investments criteria. As can be seen in Table 4 below, under a minimum investment threshold of \$750,000,³³⁸ while almost 10.3 million households meet the criteria, only 1.65 million households do not currently qualify as accredited investors.

Table 10.4: Number of Households Qualifying Under Alternate Minimum Investments

| Minimum Investment Threshold* | Number, in Millions, and Percentage of all U.S. Households Qualifying under MI criteria | | Addition, in millions, to Current Pool* of Accredited Investors | Addition, in millions, to ‘Unconditional’ Pool** Based on Recommendations |
|--------------------------------------|--|-------|--|--|
| \$500,000 | 14.9 (0.52) | 12.1% | + 5.04 | + 10.77 |
| \$750,000 | 10.3 (0.43) | 8.4% | + 1.65 | + 6.42 |
| \$1,000,000 | 7.5 (0.36) | 6.1% | + 0.15 | + 3.83 |

Figures in parentheses are standard errors.

** Current Pool: These are households that currently qualify as accredited investors.*

*** Unconditional Pool: These are households that would, under the potential approaches, qualify as accredited investors based on \$500,000 (\$750,000) and \$2.5 million individual (joint) income and net worth thresholds respectively, and not be subject to investment limitations.*

B. Non-Quantifiable Approaches

For the potential approaches 1.D through 1.F and 2.B through 2.E, due to unavailability of adequate data, we are unable to provide reasonable estimates of the number of households or individuals that may qualify under each of these potential approaches. It is to be noted that most of these additional criteria will serve primarily as proxies for investor sophistication. We expect that the number of households that would qualify under these additional criteria will have some

³³⁸ The Commission proposed a \$750,000 minimum investments criteria in 2007. *See* 2007 Proposing Release.

degree of overlap with the households that qualify as accredited investors based on the income, net worth or minimum investments criteria listed above. We anticipate that, to the extent that the households qualifying under these do not overlap with those qualifying under the quantifiable approaches, the net effect of these non-quantifiable approaches would be to increase the size of the accredited investor pool.

C. Combined Impact of Quantifiable Approaches

Table 10.5 below presents the impact of various alternate standards on the pool of accredited investors. We assume a minimum investments threshold of \$750,000 for our analysis.

Adjusting the income and net worth thresholds solely for inflation to reflect current dollars would shrink the accredited investor pool considerably to approximately 4.4 million households, from the current pool of approximately 12.4 million households. The first three approaches under this study would result in the pool increasing to approximately 14 million households or 11.5% of total U.S. population, in terms of households. We anticipate that the non-quantifiable approaches would further expand the pool of households that would qualify as accredited investors. The table presents the estimated number of households that qualify as accredited investors under the current and potential criteria, and as a proportion of the U.S. population in terms of households.

Table 10.5: Number of Households Qualifying as Accredited Investors

| | Households Qualifying, In Millions | Proportion of Overall U.S. Household Population |
|--|---|--|
| Current Criteria: 1983 SCF <ul style="list-style-type: none"> • Individual Income: \$200,000 • Net Worth: \$1,000,000 | 1.51 (0.14) | 1.8%* |
| Current Criteria: 2013 SCF <ul style="list-style-type: none"> • Individual Income: \$200,000 • Joint Income: \$300,000 • Net Worth: \$1,000,000 | 12.40 (0.47) | 10.1% |
| Current Criteria - Inflation Adjusted (CPI): 2013 SCF <ul style="list-style-type: none"> • Individual Income: \$490,819 • Joint Income: \$600,558 • Net Worth: \$2,454,093 | 4.37 (0.24) | 3.6% |
| Current Criteria - Inflation Adjusted (PCE): 2013 SCF <ul style="list-style-type: none"> • Individual Income: \$432,265 • Joint Income: \$528,906 • Net Worth: \$2,161,325 | 5.06 (0.27) | 4.1% |
| Recommended Criteria: 2013 SCF <ul style="list-style-type: none"> • Individual Income: \$500,000 • Joint Income: \$750,000 • Net Worth: \$2,500,000 • Conditional Qualification: <ul style="list-style-type: none"> • Individual Income Between \$200,000 and \$450,000, • Joint Income between \$300,000 and \$750,000 • Net Worth Between \$1,000,000 and \$2,500,000 • Minimum Investment: \$750,000 (Assumption) | CPI-Based Inflation 14.04** (0.78) | CPI-Based Inflation 11.5%** |
| | PCE-Based Inflation 14.01** (0.78) | PCE-Based Inflation 11.4%** |

Figures in parenthesis are standard errors.

* Proportion for 1983 is calculated based on 1983 SCF population of 83.9 million households. Household population in 2013 SCF is 122.5 million.

** Not including the impact of potential approaches 1.D through 1.F or 2.B through 2.E.

While the number of qualifying households under the recommended criteria would increase over the current accredited investor pool, the composition of the pool would change as the number of households that would not have any investment limitations would decline from the current level of 12.39 million to 10.77 million. It is therefore possible that the amount of capital available for investment in Regulation D offerings could be lower than the current amount due to the investment limitations chosen for certain levels of income and net worth. Table 10.6 below presents the composition of the accredited investor pool if the first three approaches were implemented, based on investment limitations.

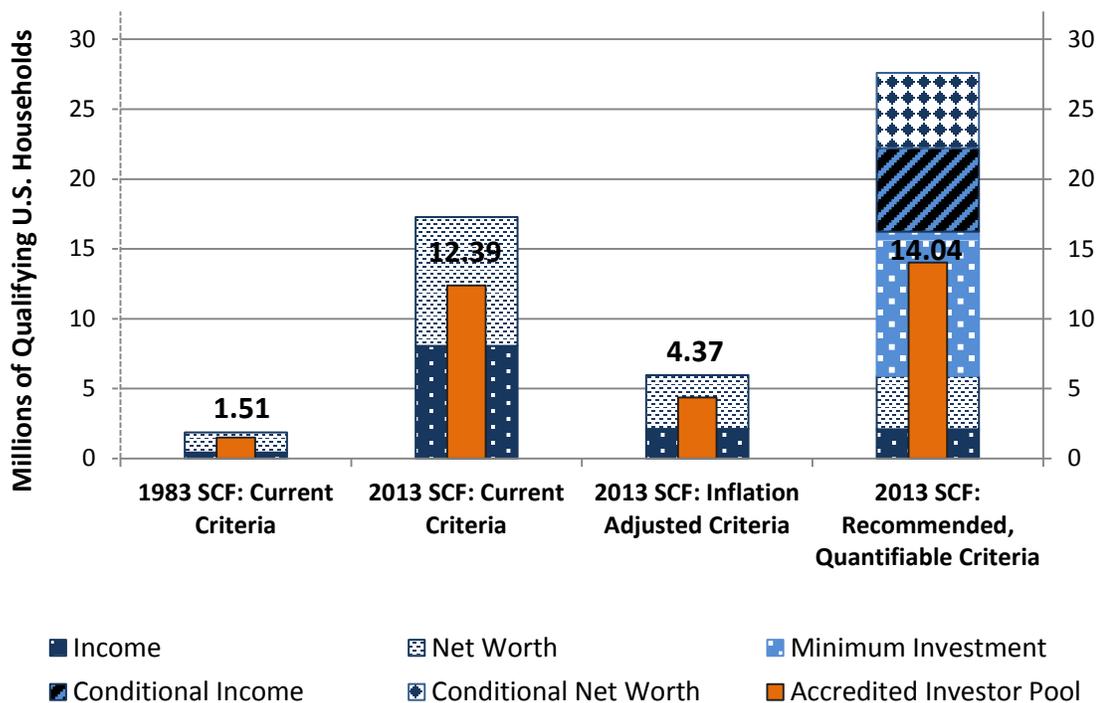
Table 10.6: Households Qualifying As Accredited Investors under Recommended Criteria

| | Households Qualifying, In Millions | |
|--|---------------------------------------|------------------------|
| | CPI-Based Inflation | PCE-Based Inflation |
| (A) Unconditional Qualification (No Investment Limitation) <ul style="list-style-type: none"> New Income and Net Worth Thresholds Minimum Investment Criteria of \$750,000 (<i>assumption</i>) | 10.77 | 10.77 |
| (B) Conditional Qualification (10% Investment Limitation) <ul style="list-style-type: none"> Individual Income between \$200,000 and \$500,000 and Joint Income between \$300,000 and \$750,000 Net Worth Between \$1,000,000 and \$2,500,000 | 3.27 | 3.24 |
| Total Households Qualifying As Accredited Investors: (A) + (B) | 14.04 | 14.01 |

Figure 10.1 below presents the number of households that qualify as accredited investors under different sets of criteria, using CPI-based inflation. Households qualifying under each criteria are shown in the stacked bars. Since some households qualify under multiple criteria

(e.g., income greater than \$200,000 and net worth greater than \$1 million), the number of accredited investor households (orange solid bar) is smaller in magnitude than the stacked bars.

Figure 10.1: Millions of U.S. Households Qualifying as Accredited Investors under Different Criteria³³⁹



D. Number of Accredited Investors that May Invest in Regulation D Offerings

The proportion of the U.S. population that qualifies as accredited investors has grown from approximately 1.8% of the population in terms of households, to approximately 10.1% of the population (Table 10.5 above), and if the proposed approaches in 1.A, 1.B and 2.A are adopted, the pool could grow to approximately 11.5% or more of U.S. households. Data from the 2013 SCF also shows that approximately 95% of households held some form of financial

³³⁹ Assuming a minimum investments threshold of \$750,000.

asset, including approximately 49% of U.S. households that held stock directly or through mutual funds, pension funds, trusts or annuities.

The data above and in the preceding tables provides an estimate of the overall pool of qualifying households in the United States. It does not, however, represent the actual number of accredited investors that do or would invest in the Regulation D market, or how that number would change if the approaches recommended for consideration in the study were adopted.³⁴⁰ Form D filings do not provide a break-down of investors by type – institutions or natural persons – that invested in an offering.³⁴¹ In addition, because there is no requirement to file an amended Form D upon completion of an offering, reported information in the Form D filings may not reflect the actual number of accredited investors who participated in any particular offering.

Whether individuals who qualify as accredited investors will invest in private offerings is likely largely a function of their risk aversion.³⁴² One way to obtain an upper bound for potential Regulation D investors is to consider the number of households that hold retail equity (*i.e.*, direct investment in stock). Assuming publicly-traded retail equity investments are a gateway to participation in private capital markets, accredited investors with publicly-traded retail equity investing experience are more likely to participate in private offerings than accredited investors without retail investing experience.

Table 10.7 below presents the proportion of U.S. households with direct retail stock

³⁴⁰ In addition, the data does not provide insight into whether increasing the size of the accredited investor pool would result in an increase in private offerings compared to public offerings.

³⁴¹ Initial Form D filings for the period 2009-2014 indicate that approximately 250,000-300,000 investors have invested in new Regulation D offerings annually. This number includes entities as well as natural persons.

³⁴² Risk aversion measures an investor's appetite for risk. A "risk-tolerant" investor would opt for an investment opportunity that has more uncertain payoffs than an opportunity with more certain, but possibly lower expected payoffs.

investments.³⁴³ The data indicates that less than 14% of U.S. households participate in the retail equity market.³⁴⁴ For the current accredited investor pool, the retail equity market participation rate is much higher at approximately 49%. This would imply that the actual number of accredited households that would potentially invest in private offerings is likely to be at least half of the overall pool of 12.5 million, or approximately 6.25 million households. Under the potential approaches recommended for consideration, the number of accredited households that would potentially invest in private offerings would increase to 6.9 million households, or approximately 53% of the pool.

Table 10.7: Proportion of U.S. Households With Direct Retail Stock Investments

| Amount Invested Directly in Stocks | Overall Population | Accredited Investor Pool: Current Standards | Accredited Investor Pool: Recommended Standards |
|---|---------------------------|--|--|
| At Least One Stock | 13.8% | 49.2% | 49.1% |
| At Least \$100,000 | 4.2% | 29.2% | 28.3% |
| At Least \$500,000 | 1.8% | 16.6% | 15.1% |

Source: 2013 SCF

E. Profile of Accredited Investor Pools Qualifying Under Current Standards and Recommended Standards

In this section we provide a brief overview of certain demographic characteristics of the estimated accredited investor pool, based on the current and potential criteria. We also include

³⁴³ Not including equity holdings through mutual funds, pension funds and other non-retail investments.

³⁴⁴ U.S. household direct retail equity investment participation has declined in recent years. For example, the participation rate was reported to be more than 15% in the 2010 SCF survey and 17% in the 1992 SCF survey. A 2003 study indicates that U.S. household participation in direct stock ownership was 19% in 1998. Luigi Guiso, Michael Haliassos and Tullio Jappelli, *Household Stockholding in Europe: Where Do We Stand and Where Do We Go?*, Economic Policy, Vol. 18, No. 36 (Apr. 2003).

U.S. population (in terms of households) characteristics in order to provide a comparison. The data underlying these charts was obtained from the 2013 SCF.

As can be seen below, accredited investors tend to be older, more highly educated and self-employed in greater proportions, relative to the general population.

Figure 10.2: Age Profile of Current and Estimated New Accredited Investor Pools

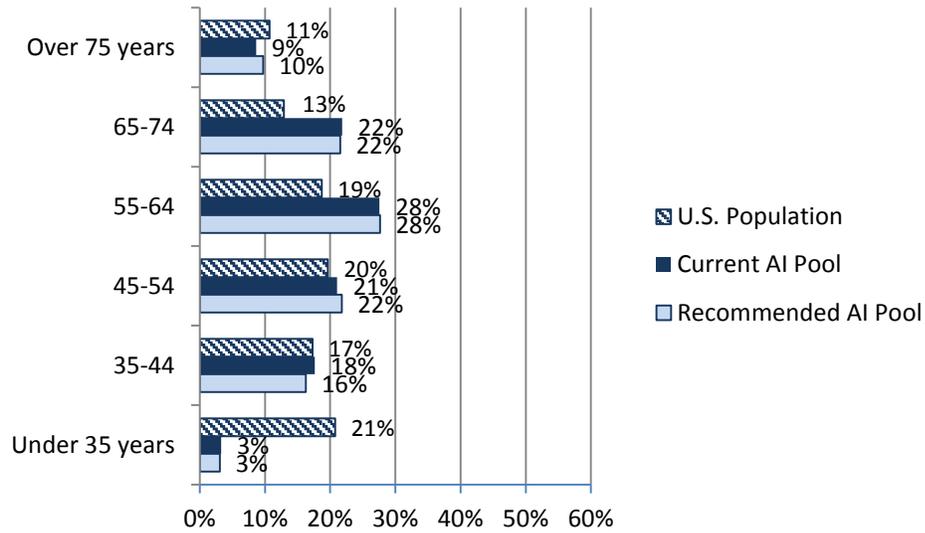


Figure 10.3: Education Profile of Current and Estimated New Accredited Investor Pools

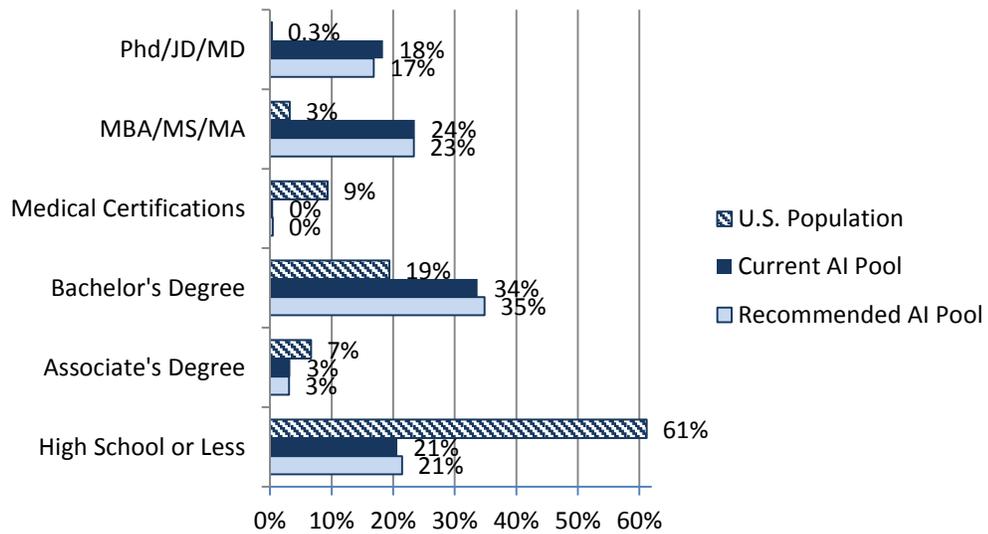


Figure 10.4: Working Status of Current and Estimated New Accredited Investor Pools

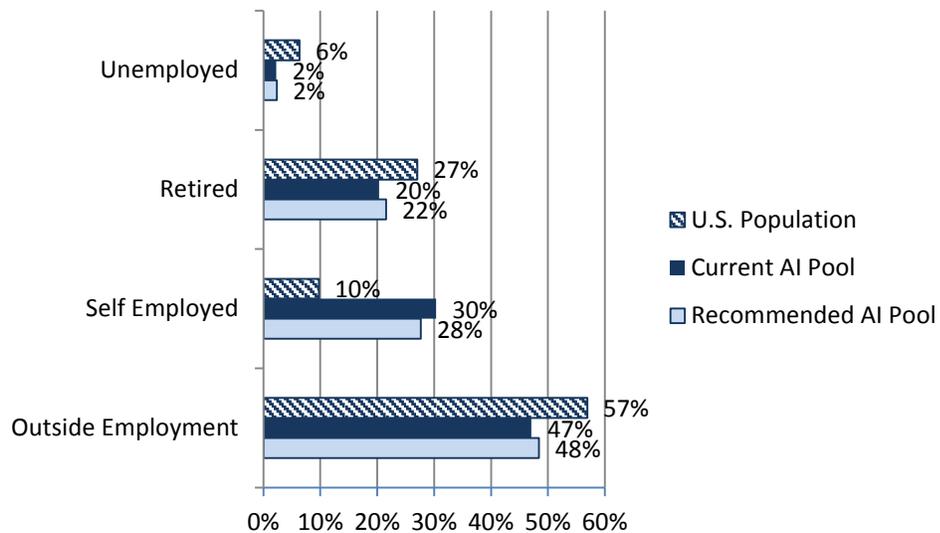
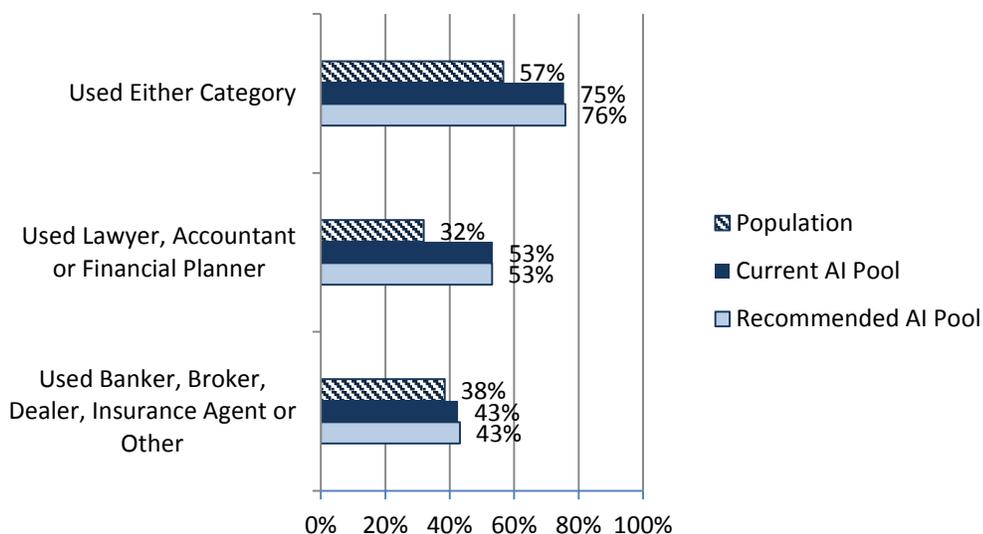


Figure 10.5 below shows that three quarters of accredited investors rely on professionals³⁴⁵ for making their investment decisions. Analysis of data in the 2013 SCF shows that 43% of accredited investors reported obtaining investment information from a banker,

³⁴⁵ Figure 10.5 is based on data from the 2013 SCF. Certain of the categories identified as “professionals” in Figure 10.5 may not be considered “investment professionals” as that term is used traditionally with respect to providing investment assistance.

broker, dealer, insurance agent, other institutionalized source or investment seminar and 53% of accredited investors reported relying on a lawyer, accountant or financial planner as sources of information for investment decision-making.

Figure 10.5: Usage of Professionals Amongst Accredited Investors



F. Geographic Distribution of Accredited Investor Households

The public version of the SCF database does not provide information regarding geographical location of households. As a result, we are unable to identify where households that qualify as accredited investors are likely to be concentrated.

The Federal Reserve Board’s *2013 SCF Chartbook*³⁴⁶ provides information on median and mean income and net worth of U.S. households based on four regions categorized as Northeast, Midwest, South and West. The data is presented in Table 10.8 below. The data shows that household income and net worth tend to be much higher in the Northeastern and

³⁴⁶ <http://www.federalreserve.gov/econresdata/scf/files/BulletinCharts.pdf>.

Western regions. This indicates that households that would qualify as accredited investors are more likely to be located in these two regions.

Table 10.8: U.S. Households Income and Net Worth, By Region (U.S. Dollars)

| | Northeast | Midwest | South | West |
|---|------------------|----------------|--------------|-------------|
| Mean Household Income (before-tax) | \$107,200 | \$75,200 | \$77,900 | \$98,300 |
| Median Household Income (before-tax) | \$58,300 | \$44,200 | \$42,600 | \$50,700 |
| Mean Household Net Worth | \$630,200 | \$448,100 | \$451,500 | \$682,900 |
| Median Household Net Worth | \$129,800 | \$75,900 | \$69,500 | \$86,600 |

The U.S. Census Bureau (the “USCB”) provides data on number of households that have net worth greater than \$1.5 million by state. The most recent data available on the USCB’s website is for the year 2004. Based on available data for 2004, California had the largest percentage of households (16.5%) with net worth greater than \$1.5 million. Other states with the largest percentage were Florida (9.1%), New York (7.7%), Texas (4.9%) and Illinois (4.6%).³⁴⁷ The states with the lowest percentage were Wyoming, Vermont, Alaska and North Dakota.

Similarly, 2009 census data shows that California had the largest percentage (16.2%) of households with income greater than \$200,000. The other states with the largest percentage were New York, Texas, New Jersey and Florida.³⁴⁸ With regard to states of solicitation, the Form Ds

³⁴⁷ See Table 719. *Top Wealth Holders With Net Worth of \$1.5 Million or More--Number and Net Worth by State: 2004*, available under the 2012 Statistical Abstract at <https://www.census.gov/prod/2011pubs/12statab/income.pdf>. The table for 2001 provides data for households with net worth greater than \$1 million. The ranking of top five states is the same as that for 2004.

³⁴⁸ See Table 706. *Household Income--Distribution by Income Level and State: 2009*, available under the 2012 Statistical Abstract at <https://www.census.gov/prod/2011pubs/12statab/income.pdf>.

for most offerings indicate the ‘All States’ option. The next highest number of Regulation D offerings were solicited in Florida (5.9%), followed by California (5.6%), Texas and New York.

G. Future Indexing for Inflation

Under the approach identified in 1.C, the dollar-amount thresholds in the accredited investor definition would be adjusted every four years to reflect inflation. The quadrennial-adjusted dollar amounts would be rounded to the nearest multiple of \$10,000. Adjusting the thresholds for inflation in the future would help to maintain the income, net worth and investments requirements in real dollar terms, so that the accredited investor thresholds do not erode over time. Table 9 below presents data (rounded to nearest \$10,000) on current, potential and future (estimated) income, net worth and minimum investment thresholds. We use average CPI-based inflation for the past 20 years (approximately 2.37%³⁴⁹) to obtain the inflation rate estimate for future years.

³⁴⁹ Underlying data obtained from Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers.

Table 10.9: Thresholds under Accredited Investor Standards

| | Current Thresholds | Recommended Thresholds | Recommended Thresholds: December 2018 | Recommended Thresholds: December 2022 |
|----------------------------|-------------------------------|-----------------------------------|--|--|
| Individual Income | \$200,000 | \$500,000 | \$550,000 (\$540,000) | \$600,000 (\$580,000) |
| Joint Income | \$300,000 | \$750,000 | \$820,000 (\$810,000) | \$900,000 (\$870,000) |
| Net Worth | \$1,000,000 | \$2,500,000 | \$2,750,000 (\$2,700,000) | \$3,020,000 (\$2,920,000) |
| Minimum Investments | | \$750,000 | \$820,000 (\$810,000) | \$900,000 (\$870,000) |
| Minimum Investments | | \$1,000,000 | \$1,100,000 (\$1,080,000) | \$1,210,000 (\$1,170,000) |

Figures in parenthesis show the amounts when we use PCE-based inflation of 1.94% for the 20-year period.

Increased thresholds due to inflation adjustment could decrease or increase the size of the accredited investor pool, depending on the rate at which personal income or net worth fluctuates, relative to the inflation rate. For example, all else remaining constant, a higher rate of income growth in nominal terms than the inflation rate would result in an expansion in the pool of accredited households qualifying on an income basis, relative to our baseline numbers.

Data from the USCB's Current Population Survey shows that U.S. household income has increased in nominal terms, on average, by 2.65% per year over the last 20 years.³⁵⁰ This is

³⁵⁰ Data available at: <https://www.census.gov/hhes/www/income/data/historical/inequality/>. Household income is defined to include wages or salary, farm and non-farm income, social security, transfer payments, investment income including rental income, unemployment/veterans' compensation, alimony or child support.

higher than the average annual inflation of 2.37% actually observed over the same period. The data also shows that household income has grown at a faster average annual rate for the top quintile of the households (3.07%), and was even higher (3.14%) for the top five percent of the households. If historical trends hold in the future, adjusting accredited investor thresholds for inflation will not shrink the pool of accredited investors, relative to the number of households that would qualify based on approaches identified for consideration in the study.