



Will Angels Lose Their Wings?

Shriram Bhashyam
Founder & Head of Legal Affairs, EquityZen

The Securities and Exchange Commission (“SEC”) is due to review the standards for qualifying as an accredited investor this summer. The results of that review could lead to big changes, including raising the bar for qualifying as an accredited investor, which would disqualify many current angel investors from investing in startups. Such a change would also stifle capital formation. Specifically, the SEC will study whether the current standards for individuals, thresholds based on income and net worth, are adequate standards and whether the thresholds should be adjusted.

In this article, we anticipate what the SEC will consider when it revisits the accredited investor criteria. Current standards for individuals, based on net worth and income, do not accurately identify the pool of investors with sufficient knowledge to make private investments, thereby adversely impacting capital formation due to the limited pool of eligible investors. Additional standards, which are better proxies for investor sophistication, ought to be considered for implementation. These standards, if implemented, would likely increase the pool of investors eligible to make private investments, thereby enhancing capital formation, with minimal impact to investor protection.

1. Background

1.1. Regulation D

Most startups raise capital through private placement transactions pursuant to the SEC's Regulation D. Reg. D enumerates exemptions in the securities laws that allow a company to issue securities without having to register those securities. The exemptions, Rules 504, 505, and 506 of Reg. D, vary based on the size of the offering, as well as the number and types of investors.

RULE	OFFERING LIMIT	INVESTOR LIMIT
Rule 504	\$1million in any 12 month period	None
Rule 505	\$5 million in any 12 month period	Accredited investors: unlimited Non-accredited investors: 35
Rule 506	None	Accredited investors: unlimited Sophisticated non-accredited investors: 35

Among the three exemptions, Rule 506 is the most commonly used, including among startup issuers, because of the relative freedom in terms of offering size and accredited investor participation. An SEC study based on Form D filings made in 2009 and 2010 reveals that of

issuers claiming a Reg. D exemption, 55.4% issued securities under Rule 506, 21.1% issued securities under Rule 504, and 19.4% issued securities under Rule 505.¹

Reg. D offerings are among the most popular ways for companies to raise capital, so any changes to the standards for accredited investors will directly impact the reach of a principal avenue for capital formation. In 2012, \$902 billion were raised in Reg. D offerings, dwarfing the nearly \$250 billion raised in public equity markets, and almost equal to the amount raised in public debt markets (about \$950 billion).²

1.2. Accredited Investors: A Brief History

Rule 501 of Reg. D defines accredited investor as:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
3. a charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person;
7. a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.³

For angel investors, the key criteria are (6) and (7) (and to a lesser extent criterion (5) for angel networks).

The accredited investor standard has been relatively untouched since its adoption in 1982 as part of Reg. D.⁴ The income and net worth tests were intended to be proxies for sophistication, financial experience, and bargaining power.⁵ Since its adoption in 1982, the

¹ See Vlad Ivanov and Scott Bauguess, *Capital Raising in the US: The Significance of Unregistered Offerings Using the*

² Vladimir Ivanov and Scott Bauguess, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012*, available at <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf>.

³ 17 C.F.R. §230.501 et seq, (2013).

⁴ Standards for investing in unregistered offerings, including private placements, have a long history that precedes the adoption of the accredited investor standard. That discussion is beyond the scope of this article.

⁵ See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 For Transactions Involving Limited Offers and Sales, 46 Fed. Reg. 41791 (Aug. 18, 1981).

accredited investor standard has been twice amended. In 1988, the joint income threshold of \$300,000 was introduced.⁶ The standard was last amended in 2011 (taking effect in 2012) pursuant to Dodd-Frank Act, which required that the value of one's primary residence be excluded from the calculation of net worth.⁷

The Dodd-Frank Act, signed into law in 2010, also requires that the SEC undertake a review of the definition of accredited investor four years from its enactment (and at least every four years thereafter), which brings us to this summer.⁸

2. What to Expect

The upcoming SEC report will be an important view into how the accredited investor standard may change. Public statements by the SEC and legislators reveal the factors the SEC will consider in its report, which may end up in amendments to the accredited investor standard.

2.1. The Heart of the Matter

In our view, the core of the pending SEC report, and any resulting changes to the accredited investor standard, will revolve around whether income and net worth are adequate criteria to determine the pool of investors who do not need the protection of a registered offering. Are financial criteria too blunt of an instrument? While such criteria may be relevant to determine ability to withstand loss, it may not accurately capture investor sophistication. Additional criteria that speak to sophistication ought to be considered. Additionally, the SEC is charged with balancing the dual interests of investor protection and capital formation for businesses. Broadening the standards will increase the pool of accredited investors, and hence facilitate capital formation. However, it may erode investor protection by allowing access to private placement transactions to investors who do not have the financial resources or sophistication to bear the risks of such investments, such as angel investments.

2.2. Should Income and Net Worth Be Adjusted?

The principal criteria for individual investor accreditation are the income and net worth factors. The numerical thresholds have largely remained in place since their adoption in 1982, save for the addition of a household income threshold and the removal of the value of one's primary residence in the net worth calculation (see Section 1.2 above). The SEC will no doubt revisit the existing thresholds in its upcoming report to Congress. In fact, the SEC sought public comment on the net worth and income criteria, including adjusting their

⁶ Regulation D Revisions, 53 Fed. Reg. 7866 (Mar. 10, 1988).

⁷ Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81793 (Dec. 29, 2011). *See also* section 413(a) of the Dodd-Frank Act.

⁸ *Id.*

thresholds, in its rule proposal for allowing general solicitation of private placements.⁹ Specifically, the SEC asked whether:

- the income and net worth tests are appropriate for determining whether an individual has sufficient knowledge and experience in finance and business that she is capable of evaluating the merits and risks of an investment;
- the current thresholds for income and net worth are appropriate and if they should be adjusted for inflation; and
- the thresholds should be based on a formula rather than tethered to fixed dollar amounts.¹⁰

All else being equal, increasing the income and net worth requirements would reduce the pool of eligible investors and, consequently, negatively impact capital formation. Nonetheless, adjusting for inflation seems intuitively reasonable. However, such a change would dramatically reduce the ranks of accredited investors. A study by the U.S. Government Accountability Office¹¹ (the “GAO Report”) found that adjusting the net worth threshold for inflation, from \$1 million to \$2.3 million, would decrease the number of qualifying households by about 57%, from 8.5 million to approximately 3.7 million.¹² Additionally, the table below highlights hypothetical adjustments and their impact on the number of eligible investors, as found by the GAO Report.

INCOME THRESHOLD		NET WORTH THRESHOLD	
Threshold	Number of Households	Threshold	Number of Households
\$100,000	21.6 million	\$250,000	23.2 million
\$200,000	6.1 million	\$1,000,000	8.5 million
\$300,000	3.3 million	\$1,750,000	4.6 million
\$400,000	2.4 million	\$2,500,000	3.4 million
\$500,000	1.7 million	\$3,250,000	2.7 million

2.3. Better Proxies for Sophistication

In addition to revisiting the income and net worth criteria, the SEC will also look to alternative criteria. Zooming out, the purpose of unregistered offerings is to facilitate capital formation while still carrying out the legislative goal of investor protection by limiting participation in unregistered offerings to those investors who don’t need the protections offered by registration. With that in mind, net worth and income alone are not the only proxies for determining the pool of investors who don’t need the protection of registration.

⁹ Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44830 (Jul. 24, 2013), available at <http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16884.pdf>.

¹⁰ *Id.*

¹¹ Alternative Criteria for Qualifying as an Accredited Investor Should be Considered, Government Accountability Office (July 2013), available at <http://www.gao.gov/assets/660/655963.pdf>.

¹² *Id.* at 18.

In fact, the current standards for individuals likely exclude many adequately sophisticated and knowledgeable investors. For example, certain licensed professionals, such as Certified Financial Analysts (“CFAs”) and Certified Public Accountants (“CPAs”), may not meet the income and net worth standards but are in fact adequately sophisticated in business and finance to evaluate the merits and risks of private investments. Further, their participation may improve disclosure and analysis in private offerings.¹³ In addition to investors with relevant professional certifications, the SEC will also review whether investors with certain degrees, such as finance, business, or economics, should be deemed accredited.¹⁴ While the latter criterion is problematic (for example, the quality and scope of the same degree will vary across colleges and universities; additionally, real life experience teaches us that a degree alone does not make one sufficiently capable of evaluating private investment opportunities), relevant professional certifications will be seriously considered for inclusion in the accredited investor standard.

The SEC will review other alternative criteria as well. It will consider whether experienced financial professionals, such as registered investment advisers, traders, brokers, portfolio managers, counsel, and regulators, should be deemed accredited investors.¹⁵ The SEC will also review whether reliance on a qualified broker or registered investment adviser should be factored in to the definition of accredited investor.¹⁶ On this, SEC Chair Mary Jo White has noted that while the use of a professional advisor may enhance investor protection in private offerings, it does not necessarily measure the investor’s understanding of the risks involved.¹⁷ Additionally, the SEC will analyze the impact that such an allowance would have on litigious claims by investors against their professional advisors.

While there is no data yet on how these alternative criteria will impact the number of eligible investors for private investments, we expect that the upcoming SEC report will shed some light on the projected impact.

3. Conclusion

The upcoming SEC study on the accredited investor standards will provide key insight into how those standards may change. The SEC must balance investor protection against capital formation, but including additional criteria that more squarely address investor sophistication, such as relevant professional certification or use of an investment professional, would enhance capital formation without negatively impacting investor protection.

¹³ See Patrick McHenry and Scott Garrett, Letter to the Hon. May Jo White (Oct. 30, 2013), available at <https://crowdfundinglegalnews.files.wordpress.com/2014/06/letter-from-congressman-garret-to-sec-chair-white-regarding-the-definition-of-accredited-investor-oct-2013.pdf> [JA: find a more official link to this letter].

¹⁴ See Mary Jo White, Letter to Hon. Scott Garrett (Nov. 15, 2013), available at <http://www.scribd.com/doc/185441459/Letter-From-Chair-White>.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*