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THE IMPORTANCE OF ACCREDITED INVESTORS FOR Small Business Capital Formation

Small businesses are often regarded as the catalyst for economic growth in the United States. Small businesses account for the creation of two-thirds of all new jobs, and are the incubators of innovation. The majority of new jobs in the U.S. are from companies less than five years old. Raising capital is a never-ending imperative for small businesses at every turn: to explore new ideas, to exploit a new development, to expand the scope of research, to move from concept to prototype to marketable product, for manufacturing, distribution and marketing. At the beginning of their life cycles, this funding is provided by private money–initially from friends and family, then from a wider circle of acquaintances, later, perhaps, from angel investors and, ultimately, venture capitalists and private equity groups. Angel investors, for example, provide approximately 90% of outside equity raised by start-up companies and are virtually the only source of seed funding. In 2013, angels invested $25 billion in 71,000 companies.

By Gregory C. Yadley

Raising the money requires compliance with the federal securities laws and the corresponding securities laws of the various states. The primary rule: register the securities offered and sold with the U.S. Securities and Exchange Commission ("SEC") and the securities commissions of the states in which such offers and sales are made *unless* an exemption from registration is available. There are numerous exemptions for private offerings, intra-state offerings and those limited in terms of the amount of capital raised, the number of offerees or purchasers, and the character of the investors. As registration is time-consuming and expensive, smaller companies' success in raising capital is highly dependent on identification of one or more funding sources that qualify as an "accredited investor."

In particular, Rule 506 under the SEC's Regulation D is the Holy Grail, providing two paths for companies to raise unlimited amounts of money with a minimum of filings, mandated disclosure and other regulatory burdens. Rule 506(b) exempts offerings from registration where "private" sales are limited to accredited investors and up to 35 non-accredited investors. In 2011, the estimated amount of capital raised in Regulation D offerings (overwhelmingly under the Rule 506 exemption) was more than $1 trillion, about the same as was raised that year in public offerings. From September 23, 2013-September 22, 2014, there were almost 15,000 new Regulation D offerings, nearly all under the Rule 506(b) exemption. Beginning in late 2013, with the amendments to Regulation D mandated by the "JOBS Act," new SEC Rule 506(c) exempts offerings from registration in "public" sales to accredited investors where the issuer has taken reasonable steps to verify such accredited status. Significantly, qualification for exemption under Rule 506 means that the issuer does not have to comply with any substantive requirements of the states in which the securities are sold. The definition of "accredited investor" is contained in Rule 501(a)(5) and includes eight types of entities and individuals. For natural persons to be deemed accredited they must meet certain income or net worth thresholds.

Accredited investors were not counted within the numerical limit of 35 purchasers for Rule 506, were not required to meet any "sophistication" standard, and were not required to be given any of the otherwise obligatory disclosures. Regulation D, with its concept of accredited investors, became effective on April 15, 1982. Since that time, with one exception, the definition has remained unchanged. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted in the wake of the financial crisis, sought to protect investors by expanding the protective

buffer against potential economic loss of investing in private placements. The Dodd-Frank Act mandated the elimination of the investor's equity in his or her primary residence from the computation of the $1 million net worth test.

The Dodd-Frank Act required that the SEC review the accredited investor definition every four years, beginning in 2014, to determine whether it should be adjusted. In doing so, the agency has the benefit of numerous public comment letters as well as a Dodd-Frank Act mandated study by the U.S. Government Accountability Office ("GAO") and guidance from three well-informed and credible groups whose views should carry significant weight: two of the SEC's own advisory committees and the SEC Government-Business Forum on Small Business Capital Formation. Perhaps not surprisingly, the views of these diverse groups are not entirely in harmony.

Nevertheless, in reviewing and considering the information before it, this author believes the SEC would be well-advised to consider these fundamental points:

- The current "accredited investor" definition is clearly understood by investors and companies using Regulation D to raise funds in private placements, primarily under Rule 506.
- Rule 506 has worked well since 1982, and no significant fraud or abuse has been specifically traced to its use.
- Small business capital formation is critical to the health and growth of the U.S. economy and the creation of new jobs.
- Replacing a simple, objective, well-understood rule with something more complex and subjective that would significantly restrict the available pool of capital for small business is not justified.
- Any change to the accredited investor definition should be based on hard evidence, and changes should be phased in to avoid disruption to the private capital markets and the businesses that depend on them for funding.

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It is undisputed that the federal securities laws must balance the needs for capital formation and investor protection. Confidence in the capital formation process is important, and finding the right balance is never easy. How one views the definition of accredited investor depends largely upon from which camp one sets out. How much protection should the government provide against loss? More importantly, how involved should the government be in determining how much risk an individual should take?

The answer to how much regulation is appropriate is elusive. The path to resolution, however, is simplified if we start from–and follow– the second basic tenant of securities law: *Provide the investor with complete and accurate information about the issuer and the securities being issued.* While this leaves some room for fraud, no law or regulation, however comprehensive or onerous, can eradicate fraud.

Regulation D and the current accredited investor definition work. Perhaps inclusion of an inflation adjustment from here on out would be appropriate. It may not be necessary, but logic suggests that a fixed number cannot always be "right" over a lengthy period of time. However, given the absence of evidence of significant fraud, incorporating an inflation adjustment back to 1982, as has been proposed by some commentators, would be foolish and unnecessary. According to SEC data,

to impose an inflation adjustment on the current thresholds from the implementation of Regulation D to the present would require increasing the net worth threshold from $1 million to $2.5 million and increasing the net income standard from $200,000 to $493,000. The Angel Capital Association has indicated that, if the net worth threshold were raised to that extent, approximately 32% of its members outside of California and the New York/New England area would not quality.

Allowing some alternative qualification of an individual as an accredited investor, based upon his or her knowledge and experience–a "sophistication" criteria"–also makes sense. Some reasonable criteria have been offered, including the following:

- prior board, executive or financial responsibility;
- relevant training or degrees, such as a CPA, CFA, MBA, JD;
- licensure as a broker-dealer or investment advisor;
- membership in an established angel group;
- previous investment experience in private offerings; and
- qualification through passing a test or completing a questionnaire.

In my view, the standard should address primarily an understanding of basic business and finance, including the risks of investing in securities. One does not have to be an accountant to invest in a bank stock or a geologist to invest in a mining stock. In some cases, it is virtually impossible for anyone to truly understand the likelihood of success or failure of the venture. Until such time as an individual has become "wealthy" (by meeting the accredited investor income or net worth thresholds), it may be sufficient if someone has a basic understanding of business and finance, and some knowledge or experience in the sector or industry in which the company operates or the investment scenario to be pursued.

While there is some appeal in providing new non-financial qualifications, the SEC should be cautious in adopting a percentage of liquid investments or similar test. In addition to the difficulty in where to set the percentage, the result can be unduly limiting. For example, if an individual's first investment is unsuccessful, he or she could be prevented from undertaking a second investment. Diversification is a primary rule of investing and even angel investors are successful only a minority of the time.

Special protection for senior citizens is also an elusive and perhaps illusory objective. Admittedly, the elderly generally live on fixed incomes, become anxious more easily and their cognitive acuity declines at some age–but not necessarily at the Rubicon age of 65. Since first round financing for new businesses is from "friends and family," curtailing or restricting parents and grandparents from financially assisting their families is bad for the economy and unwarranted.

Excluding "retirement assets" from the calculation of net worth is also problematic. Retirement assets are not a separate asset class and, for persons as they advance in age, *all* assets are, in fact, retirement assets. In any event, senior citizens under current law can deplete their "retirement assets" without penalty, including by day trading in securities of public companies on a registered securities exchange. Mandating the use of an investment advisor for certain accredited but less sophisticated investors, including senior citizens, has been recommended. Philosophically, this state paternalism has little appeal to many and for those who support such protection, agreement on where to draw the lines may be elusive. Beyond those issues, and the additional expense (and risk to the advisor), there is little data to indicate that an investment advisor would improve the likelihood of a successful investment.

The SEC has, thus far, taken the necessary time and been methodical in attempting to obtain the information and input to make a reasoned judgment as to how to modify the accredited investor definition. The agency should be at the point soon when it can do so. When the SEC acts, I hope that it will agree, as expressed in this article, that "less is more."

* An expanded version of this article was presented at the 33rd Annual Federal Securities Institute in Miami, Florida on February 6, 2015. The author would be pleased to provide a copy of the original article upon request.

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