Bond Case Briefs

Municipal Finance Law Since 1971

SEC Mulls Changes to Accredited Investor Standards.

The Securities and Exchange Commission is considering an update to the accreditation standards used to determine eligibility to participate in private securities sales.

Today's standards require that most investors in startups, real estate limited partnerships and other investments that are not traded on exchanges be accredited. To qualify as an accredited investor, one must meet one of the three following criteria:

- Have had an individual annual income of $200,000 for the past two years with an expectation that it will continue
- Have had a household annual income of $300,000 for the past two years with an expectation that it will continue
- Have a net worth of at least $1 million, excluding a primary residence

Apart from excluding the primary residence, which change was made in [2010], the financial levels have not been adjusted in over 30 years, meaning that inflation has steadily eroded their original significance, allowing millions more people over time to join the ranks. According to SeedInvest, an equity crowdfunding site, indexing these levels for inflation could reduce the number of accredited investors from 8.5 million to just 3.75 million.

The implications for the nascent crowdfunding industry is significant. Title II of the JOBS Act signed by President Obama in 2012 allowed general solicitation for investors, a change that ushered in what many are calling accredited investor crowdfunding. By allowing entrepreneurs and others to announce via social media and other internet avenues (though not restricted to the internet) issuers can suddenly attract many more investors, often investing smaller amounts than might have been required in the past.

A change in the definition of accredited investors could materially reduce the pool of investors eligible to make such investments, potentially reducing the amount of capital raised by the issuers and the platforms that support them.

In a quick, unscientific poll of leaders in the crowdfunding community for this article, 94 percent of respondents favored a change in the standard that would allow investors to qualify by virtue of education or experience alone, without regard to financial position. Such a rule could be applied either as the only means of qualification, eliminating the financial standards or as an alternative qualification method alongside the traditional—or updated—financial standards.

In the same survey, 50 percent of respondents indicated that there should be no change to the individual income standards and 38 percent responded the individual income standard should be eliminated altogether. Similarly, 40 percent of respondents says that the household test should be left alone and 47 percent says that the rule should be eliminated altogether.

Furthermore, 40 percent says the current net worth test should be left untouched and an equal percentage suggested that the net worth test should be eliminated.

No one thought a full ratchet to correct for inflation would be appropriate, though a few suggested smaller upward increases.

The following 18 reactions are representative of the comments gathered for this article:

Grady Thrasher, CEO, CrowdVested articulated the consensus view, “The income and net worth tests have long served as a proxy for financial sophistication, but they consistently exclude sophisticated investors and include unsophisticated investors. Financial resources does not equal financial sophistication.” Thrasher concluded, “Just as you have to take a test to get a driver’s license, or rent scuba gear, or engage in any number of risky activities, you should be permitted to prove you have adequate financial knowledge to participate in private offerings available to accredited investors.

“Around 7% of the US population could qualify as accredited investors today. Instead of reducing the number of people who can invest in privately held companies, we should be seeking ways to expand the growth of investments in small businesses,” commented Ken Marienau, CEO of Mission Markets. “The Dodd-Frank bill passed in 2010 excluded the value of personal residences from the calculation of net worth. This change in the 1982 calculations reduced the number of people who could qualify as accredited investors, since the net equity of principal residences represents 25% of mean personal wealth (and 75% of median personal wealth).”

“Angel investors contribute over $20 billion each year to startups and are what truly fuels innovation in America,” says Ryan Feit, CEO and Co-Founder of SeedInvest. “Reducing angel funding by instituting a higher accreditation bar would undoubtedly be devastating to startups, to jobs and to the entire U.S. economy.”

Scott Purcell, CEO of FundAmerica, commented succinctly, “An entire industry is being created to enable job creation and capital formation, changing the rules would seriously undermine the intent of the Act.”

The “accredited investor definition is an anachronism,” according to Steven Cinelli, Founder of Primarq. “Trying to morph an old law into the digital generation is an inherent waste of time, and focus should be spent on improving disclosures.”
“The bottom line is that angel funded companies hire often and hire aggressively,” says Kiran Lingam, General Counsel of SeedInvest. “To stifle angel investments in this manner [by raising accreditation standards to adjust for inflation] would be akin to shooting our economy in the foot.”

“There could be a test to demonstrate a person’s experience/understanding of finance that shows they know what they are doing and the risks they are taking by making private company investments,” notes Jason Best, Co-Founder of Crowdfund Capital Advisors. “The Internet makes information more liquid and more available to everyone.”
“I think that the standards should be eliminated,” says Karen McRae, Editor in Chief, CrowdfundingGuide.com. “Raising the standard amounts would be upholding the barrier to entry, which is the exact opposite of what these new rules should be doing.”

“It is ridiculous that income and net worth alone are used as the litmus test for an investors sophistication,” says Jason Fritton, CEO of Patch of Land. “In today’s information based economy, an individual’s knowledge base can be completely disconnected from their current financial status. Sophisticated, knowledgeable persons should be able to make their own financial decisions regardless of whether or not they are already currently wealthy. If accredited status is meant to protect an investor by judging their ability to absorb a loss, then perhaps putting a max ratio or ceiling on the total amount of capital they should be able to commit to any one project,” Fritton adds. "As it stands, an accredited investor can still lose everything on an unfortunate investment decision, regardless of how high the cutoff is for accredited status."

"This is about letting individuals make responsible decisions with their lives," notes Sherwood Neiss, Principal, Crowdfund Capital Advisors. "In this case, it includes financial decisions. Some people should have government protection (like the poor by keeping them from risking more than they can afford to lose) while others should be allowed to act as adults and take the responsibilities of their action without paternalistic government oversight."

"I believe the current standards are meant on one hand to show that the investor has some liquidity, ie, can 'afford' a loss," says Nancy Hayes, CEO of MoolaHoop. "That may or may not be true, depending on the investor's other financial activities. On the other hand, the idea that these standards demonstrate that the investor is 'sophisticated' and therefore less likely to fall prey to poor investments or worse, 'scams,' does not hold water."

"It would be a shame to see the definition of an accredited investor become even more onerous," says Jilliene Helman, CEO of Realty Mogul. "The JOBS act was meant to open up the private markets for investors, and adjusting the income or net worth requirements for accredited investors upward would serve the opposite purpose.""It's incredibly important that investors are protected, and a core focus of ours at Realty Mogul, but what we've found is that the majority of our investors are highly sophisticated. I'd hate to see those investors lose out on the opportunity to invest in private markets if income requirements are increased by the SEC," Helman concluded.

"A good education in financial issues should allow an individual, even if not accredited according to the present law, to invest in high risk but profitable securities," Fabio Bancalà, CEO at Xeelion.com. "What really matters is the amount of worth invested in risky securities, since the basis of the risk management is related to the differentiation of a portfolio."
"We are not protecting smaller investors by precluding them from participating in opportunities of their choice," says Rodrigo Nino, CEO and Founder of Prodigy Network. "Everyone should have access to the same investments irrespective to the amount of wealth they have. This will level up the playing field and our duty would be to ensure transparency, full disclosure and education for the potential investor."

"Why can anyone invest in the stock market but they can't invest in startups or emerging private companies via crowdfunding?" asks Wendy Robbins, CEO of Redcapes.com. "The regulation doesn't seem to be to 'protect the average person' it is to protect the top 1 to 10 percent's interests. I'm excited for the time (coming soon) that anyone who has taken time to educate themselves on a company can invest in a product or service and be rewarded."
"I believe that the accredited investor qualifications are long overdue for reexamination and overhaul," says Vincent Molinari, CEO and Founder of Gate Global Impact, Inc. "I would pose the consideration that many wealthy individuals lack the sophistication to fend for themselves as money by itself does to equal financial sophistication. How many mega athletes and entertainers have gone bankrupt? On the counter side, licensed securities professionals, CPA's, Attorneys, [and] MBAs who regularly advise wealthy people on strategy who may have decades of experience in the financial sector, don't qualify as accredited investors themselves simply based upon their own income or net worth."

While I recognize it has been many years since the definition has been established, I actually don't believe any change to the numeric components of accreditation is necessary, although a much more modest tinkering would be acceptable (much less than is being sought)," says Douglas S. Ellenoff of Ellenoff Grossman & Schole LLP. "I am a proponent of including other methods of measuring sophistication to satisfy the standard such as actual experience and academic credentials as well."

Manolis Sfinarolakis, Founder and Producer of Reality Crowd TV Corporation, argues for the broadest inclusion, “Common sense is something that is learned over time. Even a CPA might have no common sense, so having an arbitrary title which only takes into account ‘Book Smarts’ is not adequate and would impede the investing opportunities for the Common sense ‘Street Smarts’ investors.”

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com