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July 16, 2019

How The SEC Could Expand Access To Private Offerings

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The U.S. Securities and Exchange Commission issued a concept release on June 18, 2019, seeking public comment on a broad range of issues relating to private offerings of securities. The SEC's stated goal is "to simplify, harmonize and improve the exempt offering framework to promote capital formation and expand investment opportunities." While most of the release addresses the hodgepodge of different offering exemptions, it also provides some interesting perspective on potential changes to the definition of an "accredited investor," which determines access to most private placements of securities.

The value of such access has been highlighted of late by the extraordinary returns of early stage private investors in many recent high profile IPOs. The release introduces some novel quantitative analysis to the discussion, which seems to suggest that the current wealth based thresholds are favoring the wealthy elite, and holding back the middle class from participating in these offerings.

The definition of accredited investor in Rule 501(a) of Regulation D reflects the SEC's conclusion in 1982 that those individual investors best able to protect themselves from securities fraud were those able to withstand being fleeced, i.e., the wealthy. Thus, the basic requirements for individual investors to qualify as accredited were set as an annual income of $200,000 individually (or $300,000 with spouse), or a $1 million net worth.

The only significant change in these provisions since their adoption in 1982 is that the treatment of a personal residence in the $1 million net worth calculation was flipped in 2010 from being considered as part of an individual's net worth to being excluded from net worth, the impact of which was to make this test much harder to achieve for many individuals. Perhaps the most noteworthy thing about the income/net worth dollar thresholds is that they have not been revised in 37 years, resulting in many more individuals now qualifying due solely to the impact of inflation.

There has been much discussion of potential revisions to the definition of accredited investor since the last recession. The SEC issued a report in 2015 inviting public comments on numerous potential changes to the definition, most designed to broaden eligibility. The discussion continued among private citizens and several advisory committees and forums commissioned by the SEC over the next several years.

Further proposed changes were included in the JOBS Act 3.0 in 2017-18, but that legislation was never enacted.

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The consistent theme of all of these discussions was that the definition of accredited investor should be expanded, in order to allow broader participation in early stage private placements.

Access to private offerings has become an increasingly important issue because of the declining numbers of investment opportunities that are open to the public, coupled with the increasing amounts of available private capital and the returns it earns. The number of IPOs and public companies have shrunk dramatically since the last recession because, among other things, increased regulatory and shareholder demands make being a public company, particularly a smaller public company, less attractive.

At the same time, the availability of private capital from venture capital and private equity funds has increased dramatically, allowing companies to secure growth capital without the pain of an IPO. The Heritage Foundation recently reported that in 2018 companies raised more capital ($1.7 trillion) under Regulation D private placement offerings than was raised in the public markets.

Adding fuel to the fire are the well-publicized returns that some private investments have garnered. Numerous recent high flying IPOs, such as those of Uber and Facebook, provided phenomenal returns to the private equity and venture capital firms that invested in the earlier stages. As a result, the call has become louder and more frequent that the middle class investor is being unfairly discriminated against by being shut out from participating in these higher return offerings. This theme is in addition to the more traditional rationale of needing to increase the potential sources of capital available to small growing businesses.

The new SEC release provides some novel quantitative analysis of the prevalence of accredited investors under the current income/net worth tests, which supports a more populist rationale for broader access. First, the SEC analyzed U.S. household income and net worth by region of the country.

It concluded that the data indicates that households qualifying as accredited investors are more likely to be located in the Northeast and Western United States, as opposed to the Midwest or South. This analysis led SEC commissioner Heather Pierce to note that the effect of the current income/net worth tests was to “geographically discriminate” against capital formation in the Midwest and the South. “You shouldn’t have to be rich to get rich,” she has said.

The second area of quantitative analysis in the concept release was of the "educational attainment level" of the accredited investor pool. The release included data that demonstrated, not surprisingly, that individuals qualifying as accredited investors under the current income/wealth based criteria tend to be more highly educated relative to the general population. In particular, the data showed that individuals with advanced degrees represented 38% of the eligible accredited investor pool, but only 13% of the general population, while those with no college degree represented 54% of the population but only 17% of the eligible accredited investor pool.

There was no further analysis or characterization of this data in the release. But the point of its inclusion in the release is inescapable — that the more highly educated, upper-class elites on both coasts are being favored in these matters, to the exclusion of those less educated individuals in the heartland. This feeds quite naturally into current populist sentiment and the battle against cronyism and inequality.

The specific changes to the accredited investor rule that the SEC seeks comment on fall in two broad categories. The first relates to the existing income/net worth thresholds, where the SEC asks for input on some or all of the following approaches:

- Leaving the current income/net worth figures as they are;
- Adjusting the current figures for inflation in the future; and/or
- Adding investment limits (such as no more than 10% of net income) to the current thresholds.

The SEC also seeks comments on various other status-based (as opposed to wealth-based) criteria for determining whether an investor has the requisite sophistication, including the following:

- Professional credentials such as finance or accounting licenses;
- Meaningful disclosure of risks as a precondition for allowing investors to opt in to the less-protected status;
- Minimum investment requirements (presumably on the theory that larger amounts of investments imply greater sophistication);
- Certification or verification as accredited by financial professionals;
- Having certain levels of experience in investing in exempt offerings;
- Passing a new accredited investor examination; and/or
- Being advised by a sophisticated financial professional.

The fundamental goal in enacting the Securities Act of 1933 was to protect those not able to protect themselves in the capital markets, by imposing SEC review on securities offerings. It naturally followed that no SEC review was needed for offerings made to those that were capable of protecting themselves.

The proposals being considered by the SEC are not intended to alter that basic scheme, but rather to better define which investors are able to protect themselves, without assuming that it is only the wealthy. But the suggestions of geographic and class-based discrimination in the release have highlighted the sociological/political slant on what had been a more academic discussion of a technical capital markets issue.