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Sizing Up the SEC Accredited Investor Definition Changes

With certifications now a qualifying measure, debate ensues on which ones should be included.

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The Securities and Exchange Commission shook up the advisory industry in late August by allowing investors to qualify as “accredited investors” based on defined measures of professional knowledge, experience or certifications — including holding certain Financial Industry Regulatory Authority licenses — in addition to the existing tests for income or net worth.

In the case of individuals, “the previous rule used wealth — in the form of a certain level of income or net worth — as a proxy for financial sophistication,” the SEC stated in its 166-page plan. However, “we do not believe wealth should be the sole means of establishing financial sophistication of an individual for purposes of the accredited investor definition. Rather, the characteristics of an investor contemplated by the definition can be demonstrated in a variety of ways.”

Individuals holding FINRA’s General Securities Representative license, or Series 7; Private Securities Offerings Representative license, Series 82; and Investment Adviser Representative (state-registered advisors) license, Series 65 now qualify.

The securities regulator has said that it will reevaluate or add certifications, designations or credentials in the future by order.

“For years, the accredited investor definition was a combination net worth and/or annual income,” Nick Morgan, partner at Paul Hastings in Los Angeles, told me during the latest Human Capital podcast.

Currently, that level is set at \$1 million net worth, excluding primary residence, or an annual income of \$200,000 or for a spousal couple, \$300,000, Morgan explained. The agency received much criticism for failing to update the 38-year-old wealth threshold and indexing it to inflation.

Changes by order, Morgan said, “are much simpler procedurally than rule changes, which require comment periods and so forth.” The agency likely “started with the Series, 7, 65 and 82 because that was just the simplest and most compelling place to start.”

Jennifer Schulp, director of Financial Regulation Studies at the Cato Institute in Washington, added that including other designations or credentials by order “streamlines the process to a degree, but I would not expect to see any additions in the near term.”

However, Morgan, a former SEC senior trial counsel, said that other certifications make sense, such as Chartered Financial Analyst, CPA as well as lawyer.

Do Not Include MBA

James Allen, head of Capital Markets Policy at CFA Institute, told the agency in a comment letter that additional credentials should be limited strictly to those that display uniformly high standards, and focus specifically on investment decision-making and analysis, and should not include, for instance, general business degrees such as an MBA.

“A business degree may offer a broad understanding of business functions such as marketing, management, or strategy, or may allow students to specialize in any one of those topics,” but “such an education, in our view, would provide an insufficient understanding of the investment process for the purposes of the accredited investor definition,” Allen said.

Likewise, Allen said, “we believe the definition should exclude credentials that relate to investing only incidentally or tangentially.”

As the law firm Ropes & Gray explained in a recent brief, “qualifying as an accredited investor is significant because [they] are eligible to participate in investment opportunities that are generally not available to non-accredited investors, such as many investments in private companies and offerings by certain hedge funds, private equity funds, venture capital funds and other private funds.”

The SEC plan also expanded the list of entities that may qualify, including those that meet an “investments test.”

The newly revised definition also added:

- “Family offices” with at least \$5 million in assets under management and their “family clients,” as each term is defined under the Investment Advisers Act; and
- the term “spousal equivalent” to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

More Work to Be Done

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the SEC to review the accredited investor definition every four years.

The last change the agency made was in 2011 when it excluded, as directed by Congress, the primary residence of the investor in the calculation of net worth.

SEC Commissioner Elad Roisman, a Republican, said in a statement that he supported the agency’s changes “because they are our first steps away from the current, single criterion wealth-based system of eligibility.” However, he believes the agency should have ventured further by expanding the definition to include “knowledge-based” eligibility.

“For example, [SEC staff] who review registration statements for material disclosure and investigate potentially fraudulent activity in our markets, will not qualify as accredited investors

because the eligibility criteria are still very limited,” he said. “It certainly seems a strange outcome that so many individuals who enforce our securities laws and regulate financial markets are not considered sophisticated enough to invest in those very same markets. To me, the conclusion is that our work is not done.”

In its next review, should the securities regulator “do away with monetary thresholds altogether?” Roisman asked rhetorically. “Some argued that we should have increased the monetary thresholds, for example, by adjusting for inflation. [Yet], I believe continuing to build on this poor metric would further entrench it and the fallacy that it was an accurate measurement in the first place. The fact [is]: there was no magic to the income and wealth requirements when they were initially adopted.”

Seniors at Risk

But the two Democratic SEC Commissioners, Allison Herren Lee and Caroline Crenshaw, had a decidedly different view.

The agency’s decision not to index the wealth thresholds to inflation going forward “runs counter to widespread support for such a measure, even among groups that often diverge in their views regarding Commission policy,” the two said in a joint statement, including the agency’s Small Business Capital Formation Advisory Committee, state regulators, crowdfunders as well as a diverse group of academics.

The agency’s plan “merely states that indexing going forward would ‘reduce the potential aggregate capital supply available for exempt offerings going forward,’” Lee and Crenshaw stated. “That capital supply, however, is hardly in danger. In fact, capital raised in the private markets continues to grow at unprecedented rates, surpassing the public markets, accounting for nearly 70% of new capital raised in 2019.”

Increased investor access to information now, compared to 1982, was another reason the agency cited for not indexing the thresholds to inflation, “including through the internet and social media and, ‘powerful home computers and mobile computing devices,’” Lee and Crenshaw said.

However, “this ignores the naturally opaque nature of the private market where issuers are not required to provide the robust disclosures that are features of public offerings,” the two women stated. “No matter how powerful your computer is, you cannot access information that is not there.”

Private offerings, Lee and Crenshaw continued, “are not just less transparent, but also illiquid, and prone to fraud.”

In response to evidence of fraud in the private market, the SEC argues “that ‘commenters did not provide information that would indicate that any such incidents of fraud in the private markets are driven or affected by the levels at which the accredited investor definition is set,’” Lee and Crenshaw stated.

“This quite plainly misconstrues the point: it’s not that the accredited investor definition somehow causes fraud, it’s that it allows more investors to be exposed to the risks of fraud” — mainly seniors.