Mr. Keith J. Johnson, JD
[redacted]

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

March 6, 2016

Re: File No. 4-692 – Comment on the Report on the Review of the Definition of "Accredited Investor"

Dear Mr. Fields,

The Securities and Exchange Commission ("SEC") submitted the Report on the Review of the Definition of Accredited Investor ("Report") on December 18th, 2015[1] in regard to a proposed rule redefining the definition of "accredited investor" within Regulation D ("Reg D").[2] The SEC exhaustively reviewed the current definition in relation to the economic inflation since its passage in 1982—the SEC correctly notes that the unadjusted minimum income and net worth thresholds for natural persons have significantly increased the pool of potential accredited investors. This Comment solely focuses on the following recommendations made by the SEC: 1) adding investment limitations to current individuals with an income of $200,000 or $300,000 if

[1] *See* U.S. Securities and Exchange Commission, *Report on the Review of the Definition of "Accredited Investor"*, U.S. Securities and Exchange Commission, Dec. 18, 2015, *available at* http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf [hereinafter "Report"].
[2] *See* 17 C.F.R. § 230.501(a) (2013).

married filing jointly, both in the most recent two years,[3] or a net worth exceeding $1 million;[4] 2) adding an inflation-adjusted income and net worth bright-line test with no investment limitations;[5] 3) indexing financial thresholds to adjust for inflation every four years;[6] 4) grandfathering in current investors of an issuer;[7] and 5) allowing individuals with other measures of sophistication to qualify as accredited investors despite not meeting the income or net worth tests.[8]

I. ADDING INVESTMENT LIMITATIONS TO THE CURRENT INCOME AND NET WORTH TESTS

While the usage of Reg D offerings has been shown to be a significant and increasing portion of capital raising—accounting for over $1.25 trillion in 2014, up from under $750 billion in 2009[9]—both the income and net worth tests for natural persons to qualify as accredited investors have never been adjusted since their enactment in 1982 and 1988.[10] Adjusting for inflation, a person's income of $200,000 in 1982 would be approximately $490,000 in 2015, and a married couple's income of $300,000 in 1988 would be approximately $600,000 in 2015.[11] Further, $1 million in net worth 1982 approximately equals $2.45 million in 2015.[12] While these numbers certainly detail the effect of inflation, it is also helpful to know what the inflation

[3] *See supra* note 2, at § 230.501(a)(6); *see also* Report at 90.
[4] *See supra* note 2, at § 230.501(a)(5); *see also* Report at 90.
[5] *See* Report at 90–91.
[6] *Id.* at 91.
[7] *Id.* at 93.
[8] *Id.* at 93–96.
[9] *See* Scott Bauguess, Rachita Gullapalli & Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014*, U.S. Securities and Exchange Commission, Oct. 2015, *available at* https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf [hereinafter "*Capital Raising*"].
[10] *See* Report at 89.
[11] *See supra* note 3; *see also* Federal Reserve Bank of Minneapolis, *What is a dollar worth?*, *available at* https://www.minneapolisfed.org/ (allowing a user to estimate the value of a dollar amount in a given year adjusted for inflation).
[12] *Id.*

adjusted amount of $200,000 and $1 million in 2015 was in 1982—approximately $80,000 and $400,000, respectively.[13] The SEC saw fit that individuals with income or net worth at those levels do not have the sophistication to be accredited investors. Natural persons with income or net worth at that level clearly required the protections afforded by registration under the Securities Act of 1933 ("1933 Act"); allowing the 2015-equivalent to invest in unregistered securities goes against the entire purpose of the 1933 Act and the SEC's own mission to protect investors.[14]

The numbers show how inflation has had a drastic effect on the potential number of accredited investor natural persons. However, outright increasing the income and net worth tests to readjust for inflation is not the approach this Comment recommends. One issue with creating a bright-line income and net worth test is that it assumes individuals at or above those levels are sophisticated enough to invest in unregistered securities, that individuals below those levels are not sophisticated and require the protections afforded by registration, and that income and net worth alone is enough of a measure of a person's sophistication. Increasing the income and net worth levels do not adequately address these assumptions.

While it is often true that income is directly correlated to a person's sophistication, it is not necessarily the case. For example, obvious individuals exist who likely are sophisticated enough to fend for themselves—such as a hedge fund manager, managing director at an investment bank, and other such individuals whose position, income and industry imbue them with both the income and intellectual capacity to judge an investment on its merits without the usual

[13] *See* Federal Reserve Bank of Minneapolis, *What is a dollar worth?*, *available at* https://www.minneapolisfed.org/.
[14] U.S. Securities and Exchange Commission, *What We Do*, U.S. Securities and Exchange Commission, Jun. 10, 2013, *available at* https://www.sec.gov/about/whatwedo.shtml.

disclosures required by the 1933 Act. However, other individuals may not be in a position to have developed the skillset to be the sophisticated investor hypothesized by the 1933 Act, but still earn the requisite minimum income or have amassed the net worth via accretion or inheritance.

The current definition, by its very nature, is both over-inclusive and under-inclusive—the SEC admits as much in its own report.[15] In 2014 the median household income was $53,657,[16] significantly below the minimum incomes of $200,000 and $300,000. The current state of inflation has accordingly not resulted in the average American meeting the accredited investor definition, meaning the risk posed by an average person or family investing in unregistered securities does not yet exist. Still, inflation has pushed the two closer together today than they were in 1982 when the income test was first enacted.

Presently, there are two competing positions. The first is obvious and the SEC does well to address it throughout the Report—the inflation adjusted income test for a natural person in today's dollars is drastically more than what is currently allowed. The second pushes back on that stance though, arguing that income alone is not a competent indicator of a person's sophistication, and the minimum income required is still significantly more than the average American household earns.

The income and net worth tests were not perfect when enacted, as noted by the SEC when it focuses on the definition's shortcomings.[17] Therefore, the proposal to amend the definition

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[15] *See* Report at 43–46.
[16] Carmen De-Navas-Walt & Bernadette D. Proctor, *Income and Poverty in the United States: 2014*, United States Census Bureau, Sep. 2015, *available at* https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-252.pdf.
[17] *See supra* note 15.

by retaining the current income and net worth tests, and adding investment limitations is a sound proposal. The proposal suggests those currently earning or eventually earning the minimum income or worth the minimum net worth may invest in unregistered securities. Limitations would logically be set on an income-based approach—likely something akin, but not necessarily an exact copy, to the Crowdfunding Exemption of Title III to the Jumpstart Our Business Startups Act ("JOBS Act").[18]

II. INFLATION-ADJUSTED INCOME AND NET WORTH TESTS WITH NO INVESTMENT LIMITATIONS

If the SEC redefines the accredited investor definition to place investment limitations on natural persons without creating a new inflation-adjusted income and net worth bright-line test, it would eliminate one of the hallmark definitions of accredited investors for Reg D offerings. As discussed supra, the income and net worth tests were enacted in 1982 because those natural persons were assumed to be sophisticated and could fend for themselves. That assumption remains true—despite the over- and under-inclusive nature also discussed supra—today as it did in 1982, and will remain so in the future.

As such, the SEC, if it adds investment limitations, must also amend the definition to adjust the income and net worth tests by accounting for the rate of inflation since 1982. While estimates put those numbers to be approximately $490,000 to $600,000 and $2.45 million,[19] this Comment does not recommend the exact amounts to be adopted. Amending the income and net worth tests would allow the original intent of the definition to remain, and it would

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[18] *See generally* Jumpstart Our Business Startups Act of 2012 § 302(a), 15 U.S.C. § 77d (noting an investment maximum of $2,000 or 5% of annual income for those with annual income under $100,000, and 10% of annual income not to exceed $100,000 for those earning $100,000 per year or more).
[19] *See* supra notes 3, 11.

ensure that the past course of affairs for Reg D offerings would continue on the same trajectory.

III. INDEXING INCOME AND NET WORTH LEVELS FOR INFLATION READJUSTMENT

The SEC Report and the discussion in this Comment directly propose prudent changes to the current accredited investor definition for natural persons. However, adding investment limitations and increasing the non-limited income and net worth tests is per se insufficient. Logically, adding limitations and then readjusting the minimums will eventually result in this same issue arising in the future, when the minimums are again too low accounting for inflation.

Therefore, creating an index to readjust for inflation is a sensible solution to the problem. Rather than open up the definition to public comment and propose an amendment periodically, the SEC proposes an index that would adjust the income and net worth to account for previous years' inflation—it recommends every four years.[20] Indexing the amounts to account for a pre-determined inflation rate is likely not the wisest choice, because it would assume a rate of inflation before that rate is calculated. Rather than draft the proposal with that possibility, the SEC should propose a definition with an index table that utilizes another measure for readjusting. The index would be best built to cite to a rate that is determined by an organization best suited for analyzing the economic course of the United States to approximate the level of inflation. Using the Consumer Price Index set by the United States Bureau of Labor Statistics or the rate evaluated by the United States Federal Reserve would be logical choices, for example, while others exist as well.

[20] *See* Report at 91.

IV. Grandfathering in Current Investors

The SEC's proposal to redefine the accredited investor natural person will have a direct effect on those current natural persons using the present definition's income and net worth thresholds. It is indeed quite possible, and more than likely, that numerous individuals are currently earning the requisite income or worth $1 million who, if accounting for inflation, would not meet the minimums. Grandfathering in these individuals in as exceptions to the rule would be a prudent course of action for the SEC.

However, grandfathering in these individuals so that they may invest freely, as they do now, with new unregistered securities would be contrary to the investor protection public policy. To that end, the SEC should include this proposed caveat: that investors may purchase unregistered securities as they currently do, but only as to the same issuer, and not affiliates of the issuer or other issuers.[21] If the SEC were to not grandfather these investors in, the SEC would essentially be taking away the investment approach that an investor had used previously, continues to use presently and likely will use again in the future during a follow-on offering with the same issuer. The SEC does rightly proposes a limit on this proposal; the investor would be limited to offerings by that same issuer, and not an affiliate of the issuer and certainly not another issuer entirely.[22] This recommendation will prevent any potential injustice that would be done by allowing one investor to purchase unregistered securities unimpeded while another investor cannot do so, simply because the former investor used the accredited investor exception earlier.

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[21] *See* Report at 93.
[22] *Id.*

V. Other Accredited Investor Criteria

As noted earlier and mentioned in the Report,[23] the current definition of accredited investor does preclude some individuals from meeting the accredited investor definition despite the sophistication or expertise those individuals may bring to the investor pool. Sophistication should not solely be measured by an individual's income or net worth—although that is often an appropriate indication of someone's sophistication. Many individuals in the United States are worth significantly more than $1 million. While a large number have earned that wealth, there are numerous people who, for example, inherited their fortunes but did not inherit the sophistication that typically goes along with such wealth.

The SEC does not propose creating a rule to prevent people, who can essentially be deemed unsophisticated but wealthy, from investing in unregistered securities. If these people can invest in unregistered securities, it stands to reason that people not so financially well off should also be able to invest in unregistered securities based on their actual level of sophistication determined by more appropriate measures. A list of enumerated individuals can be debated at length, and the SEC initially proposes five potential categories, only three of which this Comment addresses.

First, those individuals with a minimum amount of existing investments are the exact individuals that should be accredited investors. These individuals have direct evidence of their individual ability to analyze an investment and make a decision on whether or not to invest; further, those genuine investments will show calculable returns or losses. These factors provide more relevant evidence of a person's sophistication with finance than a simple income

[23] *Id.* at 44, 93–94

or net worth test. Neither a person's income nor their net worth, in themselves, show how well equipped an individual is at judging an investment. However, those with existing portfolios can show prima facie their sophistication.

In addition, the SEC suggests allowing persons with professional credentials, such as Series 7, to qualify for the accredited investor definition.[24] The SEC can go further—individuals such as Chartered Financial Analysts and Certified Public Accountants could also meet the sophistication standard. Such individuals have been tested on their knowledge of finance and accounting—two extremely important facets of any investment decision. Additionally, those who have taken a requisite number of course credits from an accredited university could also be accredited investors, such as those with a Masters in Business Administration or lawyers who focused on corporate law in law school or in practice. Very often all of these individuals do not meet the income or net worth tests to be considered accredited investors, but through education and examination they have been shown to be sophisticated enough to fend for themselves. In addition, people with years of experience in a financial role could also be considered, such as analysts, associates and managers of investment banks, hedge funds, private equity funds, venture capital funds, real estate investment trusts and so forth.

Finally, the SEC proposes to add a qualifier for employees of private funds to meet the accredited investor definition.[25] Those employees, as the SEC points out, have the experience and access to information to judge an investment's potential. The 1933 Act's disclosure requirements are meant to provide potential investors with all of the information they may

[24] *Id.* at 94–95.
[25] *Id.* at 95–96.

need to be able to make a thoughtful determination of whether or not to invest money in a company's securities. Many employees of a private fund could still have access to all of that information even though no 1933 Act disclosures are made and submitted to the SEC. In addition, many employees within a private fund are tasked with evaluating potential investments in unregistered and registered securities alike. Ergo, those employees are active in the business of investing in the unregistered securities professionally, and should be allowed to invest in their individual capacity.

VI. Conclusion

In sum, the SEC evaluated the current statutory definition of accredited investor and rightfully pointed out its numerous shortcomings. This proposal offers the SEC the opportunity to improve upon the accredited investor natural person definition in a number of ways. The SEC may elect to retain the current income and net worth tests, but it would be wise to add investment limitations to those levels. Additionally, the SEC should add a new income and net worth test that has no investment limitations but that is adjusted for inflation from the original years of enactment. Moreover, it would be prudent for the SEC to adopt an index so that the income and net worth tests may be readjusted going forward. The SEC should also propose an exception that grandfathers in those investors currently using the definition, but who would not meet an inflation-adjusted definition. Lastly, income and net worth are not the sole determinations of a person's sophistication; it is logical for the SEC to adopt a rule so that a wider range of qualified individuals can meet the sophistication standard in other ways that are, perhaps, more indicative of their sophistication than simply income and net worth alone.