

Proposed Law Could Breathe New Life Into Section 4(a)(5)

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When is an individual an “accredited investor” under the Securities Act of 1933? H.R. 2187, the Fair Investment Opportunities for Professional Experts Act, which recently passed in the House of Representatives and is now before the Senate Committee on Banking, Housing and Urban Affairs, may broaden the answer by expanding the definition of “accredited investor” in Section 2(a)(15) of the 1933 Act to include licensed brokers, investment advisers and other individuals with educational or professional expertise.

Background

An issuance of securities to accredited investors is exempt from the registration requirements of the 1933 Act pursuant to Regulation D, a safe harbor for the nonpublic exemption under Section 4(a)(2) of the 1933 Act, if the issuer complies with certain requirements. Regulation D — and, in particular, Rule 506 thereunder — is by far the most relied-upon exemption for private placements, with an estimated \$4.7 trillion raised in Regulation D offerings between 2009 and 2014, according to a U.S. Securities and Exchange Commission study.

An issuance of securities to accredited investors also may be exempt under Section 4(a)(5) of the 1933 Act. Section 4(a)(5), however, is a more limited exemption than Regulation D as it includes a flat prohibition against issuers engaging in “general solicitation or advertising” of the offering and is limited to offerings of \$5 million or less. Post-Jobs Act of 2012, Regulation D permits general solicitation in certain Rule 506(c) offerings and places no limit on offering size regardless of the use of general solicitation. Moreover, most issuers raising private capital prefer to rely on Regulation D because it is a safe harbor, which provides certainty with respect to the availability of the Section 4(a)(2) exemption from registration.

With respect to individuals, the definition of accredited investor, which is found in Rule 501 for Regulation D offerings and Section 2(a)(15) and Securities Act Rule 215 for Section 4(a)(5) offerings, is identical for both exemptions. An individual may qualify as an accredited investor under either exemption if it satisfies certain financial thresholds based on a person’s net worth or annual income.



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Recent Developments

Whether these financial thresholds — which have remained unchanged since the 1980s — are reliable proxies for investor sophistication has been called into question. On Dec. 18, 2015, the SEC released a report setting forth a number of alternative reforms to the definition, such as indexing all financial thresholds to inflation on a going-forward basis and treating individuals with sufficient investing experience or professional credentials as accredited investors.

Consistent with the SEC's report, H.R. 2187 seeks to modify the definition in Section 2(a)(15) to include the net worth and income tests at their current thresholds, but require the relevant financial thresholds be adjusted for inflation by the SEC every five years. While this change would only affect an individual's status as an accredited investor under Section 4(a)(5), H.R. 2187 could prompt the SEC to promulgate rule-making to adopt a similar inflation-adjustment rule under Regulation D.

H.R. 2187 also defines an accredited investor to include natural persons who are brokers or investment advisers. While brokers are already considered accredited investors under Regulation D, investment advisers are not. Thus, H.R. 2187 could provide investment opportunities for investment advisers under Section 4(a)(5) that are not otherwise available under Regulation D. Note that this provision relates to only natural persons, so it would not include investment advisers organized as limited liability companies or corporations.

Finally, and most significantly, H.R. 2187 would create new Section 2(a)(15)(E), which would require the SEC to adopt regulations affording accredited investor status under Section 4(a)(5) to natural persons who "have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment," and whose education or experience is verified by the Financial Industry Regulatory Authority or another self-regulatory organization.

The Regulation D definition of accredited investors does not contain such a provision. Thus, H.R. 2187 could make the largely forgotten Section 4(a)(5) relevant again in offerings to financially experienced investors — such as analysts, economists, industry specialists or even professors — whose net worth or individual income does not otherwise satisfy the bright-line test for accredited investors pursuant to Regulation D in offerings of \$5 million or less.

In its December 2015 report, the SEC highlighted several means of assessing financial sophistication without relying on financial thresholds, including (1) the amount of money an individual has already invested, (2) an individual's professional credentials, (3) the number of prior offerings in which the individual has participated and (4) an "accredited investor examination" that tests one's understanding of the risks involved in a private offering. The SEC also suggested that employees of a private fund be deemed accredited investors for the purpose of investing in the fund for which they work. If H.R. 2187 becomes law, the SEC likely would incorporate one or more of these designs in the congressionally mandated regulations.

Although H.R. 2187 purports to expand the definition of an accredited investor only for natural persons, it could result in a large number of corporations and other entities also qualifying as accredited investors. Under Rule 215, an entity is an accredited investor if its "equity owners" are all accredited investors.

That said, while H.R. 2187 has the potential to breathe some life into Section 4(a)(5), its impact should

not be overstated. As discussed, H.R. 2187 would not affect Regulation D unless the SEC chooses to harmonize the rules. Furthermore, offerings under Section 4(a)(5) would still be subject to the \$5 million limitation, and the prohibition on general solicitation and advertising.

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