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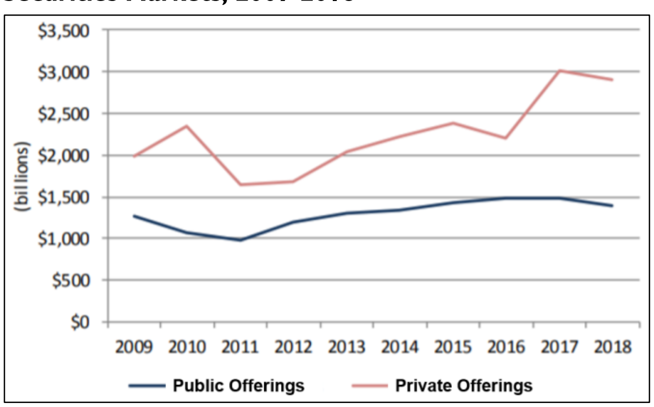
Accredited Investor Definition and Private Securities Markets

Companies turn to capital markets to raise funding from investors, a process referred to as a *securities offering*. *Public* securities offerings are open to a wide range of investors and must meet comprehensive registration requirements imposed by the Securities and Exchange Commission (SEC). By contrast, *private* securities offerings are exempt from certain SEC registration requirements and are generally available only to *accredited investors*. Hence, the accredited investor definition effectively determines who can access the private securities markets and invest in privately held companies or offerings by private funds, such as hedge funds, venture capital, and private equity.

Private Securities Offerings: Market Size, Risks, and Trade-offs

The scope of the accredited investor definition has taken on greater significance in light of recent increases in the volume of private securities offerings. In 2018, companies raised roughly $2.9 trillion through private offerings—more than double the size of public offerings (**Figure 1**).

Figure 1. New Capital Raised in Public and Private Securities Markets, 2009-2018



Source: Securities Exchange Commission.

Although private securities offerings are growing in popularity, they also present investors with greater risks than public offerings. Some of these risks derive from private offerings' reduced disclosure relative to public offerings. Without more comprehensive disclosure, investors in private offerings may be less able to make informed decisions regarding risks and pricing. In addition, private offerings are generally issued by small, medium-sized, and start-up companies, which tend to be riskier investments compared with more established publicly traded companies. Private offerings are also less liquid than public offerings, meaning that investors may have more difficulty selling these securities at desired prices and could incur losses if they are forced to sell to meet urgent cash needs.

In regulating capital markets, the SEC must balance two of its statutory mandates: investor protection and capital formation. Through the exemptions for private offerings, the SEC allows companies to raise capital without incurring the costs associated with the registration and disclosure requirements governing public offerings, while ensuring that the investors who participate in such private offerings have sufficient sophistication to take care of themselves without the protections afforded by securities law requirements. Capital formation needs may be better met if issuers can raise funds without incurring registration costs, but investor protection challenges potentially increase as more investors gain access to private offerings.

The Current Accredited Investor Definition

Under the SEC regulations, an individual must meet one of two criteria to qualify as an accredited investor (**Figure 2**).

Figure 2. Who Is an Accredited Investor?

Source: Financial Industry Regulatory Authority.

An individual can qualify as an accredited investor if (1) he or she earned more than $200,000 (or $300,000 together with a spouse) in annual gross income during each of the prior two years and can reasonably be expected to earn a gross income above that threshold in the current year or (2) he or she has a net worth of more than $1 million (either alone or together with a spouse), excluding the value of the primary residence. Institutions can also qualify as accredited investors if they own more than $5 million in assets. Moreover, a number of regulated entities, such as banks, insurance companies, and registered investment companies, automatically qualify as accredited investors. According to the SEC, an estimated 13% of all U.S. households (16 million in total) qualified as accredited investors in 2016, up from 10% in 2013, as stated in a separate SEC study.

Policy Issues

- ***Retail investor protection.*** Some commentators worry that any potential broadening of the definition could subject more retail investors to private offerings' risk exposures, which these investors may not be able to tolerate. In addition, other commentators have argued that the existing accredited investor criteria do not adequately protect wealthy but unsophisticated investors (including many senior citizens who rely on existing net worth as their sole source of financial security) from the higher risks that often accompany private securities offerings.

- ***Access to investment opportunities***. Conversely, a number of observers have argued that well-informed but less affluent investors should be allowed to invest in private offerings. According to these critics, the existing accredited investor definition amounts to a "privilege for the rich" and prevents many investors from participating in tech start-ups and other fast-growing companies.

- ***Portfolio diversification***. In recent years, there has been a shift in capital markets fundraising from public to private offerings. As the size of the private market continues to increase (see **Figure 1**), some commentators have argued that investors may enjoy diversification benefits from allocating capital across the whole universe of public and private securities.

- ***Inflation adjustments.*** Inflation adjustments are often attached to financial thresholds in SEC rules. However, the current accredited investor income and net-worth thresholds are not adjusted for inflation. A retrospective inflation adjustment could more than double the current thresholds. Per a 2015 SEC Report on the Review of the Definition of "Accredited Investors," main portions of the threshold have not been adjusted since 1982. Inflation adjustments from 1983 to 2013 would reduce the percentage of overall U.S. households qualified as accredited investors from 10% to 4%. The same study shows that around 2% of U.S. households qualified as accredited investors in 1983.

- ***Bright line test for implementation.*** In many regulatory contexts, *bright line* rules may be preferable to more general standards. The current accredited investor definition arguably exhibits the key virtue of such bright line rules insofar as it allows companies and investors to easily determine who qualifies as an accredited investor. Any new nonquantitative criterion to capture financial sophistication could therefore present trade-offs by blurring the boundaries of the accredited investor definition, potentially leading to operational delay or ambiguity.

Potential Policy Options

For many years, policymakers, regulators, and industry participants have discussed ways to alter the accredited investor definition. On June 18, 2019, the SEC published a private securities offerings concept release to solicit public input on related policy issues prior to potential future rulemaking. Examples of the proposals include the following:

- ***Accounting for other forms of investment sophistication***. Some commentators have suggested that the pool of accredited investors could be expanded to those who have received financial training or credentials or could otherwise demonstrate equivalent knowledge and understanding. In the 115th Congress, H.R. 1585, H.R. 3972, and Titles IV and X of S. 488 would have broadened the accredited investor definition. The provisions would have changed the definition to include those with qualifying license and education or experience and adjusted the thresholds for inflation every five years. The provisions also specified that family offices and family clients be recognized as accredited investors. Family offices are entities established by wealthy families to manage their wealth and provide other financial services to family members. In the 116th Congress, a group of 13 Senators sent a letter to the SEC on July 18, 2019, encouraging the SEC to adjust the accredited investor definition to include family offices and individuals with qualifying technical expertise.

- ***Allow investors themselves to opt in.*** Others have argued that individuals ought to have the option to self-certify after receiving disclosure about the risks of private securities offerings or to take an accredited investor examination to qualify as an accredited investor. For example, SEC Commissioner Hester Peirce spoke at a forum in June 2019 in support of a reform to provide options for investors to opt in. She argued that the current system of providing access to private offerings through the accredited investor definition is "geographically discriminatory" by favoring coastal regions and that she saw opening investor choice to be a potential solution.

- ***Expand the eligible accredited investor base, subject to investment limits***. Some observers have suggested that all individuals should be able to invest in private offerings, subject to certain investment limits (e.g., capped at a fixed percentage of annual gross income or net worth). This and other considerations are also discussed in the SEC's private securities offerings concept release.

Related Products

CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

CRS In Focus IF10747, *Private Securities Offerings: Background and Legislation*, by Eva Su.

CRS In Focus IF11062, *Introduction to Financial Services: Capital Markets*, by Eva Su.

CRS In Focus IF11256, *SEC Securities Disclosure: Background and Policy Issues*, by Eva Su.

CRS Report R45308, *JOBS and Investor Confidence Act (House-Amended S. 488): Capital Markets Provisions*, coordinated by Eva Su.

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