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Eliminating The Accredited Investor Concept Is Problematic

Law360, New York (March 8, 2017, 12:17 PM EST) -- On the same day that President Donald Trump signed an executive order instructing federal agencies to create task forces designed to identify regulations for potential elimination, Michael Piwowar, acting chairman of the U.S. Securities and Exchange Commission, provided what had to have been one of the first recommendations for such regulatory reform. Speaking at the Practicing Law Institute's "SEC Speaks" Conference on Feb. 24, Piwowar suggested that the commission revisit "the artificial distinction between so-called accredited and nonaccredited investors" created by Regulation D of the Securities Act of 1933 with a view toward eliminating the dichotomy.

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In a speech titled "Remembering the Forgotten Investors," Piwowar stated that there remain "men and women of our country whom securities regulation is meant to serve and protect but so often has not." An example of this type of regulation, according to Piwowar, are the registration requirements of the Securities Act and exemptions that have been created pursuant thereto. He suggested that attempting to distinguish accredited investors "who can fend for themselves from those who cannot is a line-drawing exercise fraught with peril," and contended that Regulation D, which exempts certain securities offerings from the registration requirements of the Securities Act, only deprives nonaccredited investors of access to "high-risk, high-return securities available only to the Davos jet set."

This regulatory regime, Piwowar argued, likely causes more harm than good to nonaccredited investors by creating a "blanket prohibition on their earning the very highest expected returns," and thus "exacerbat[es] inequalities of wealth and opportunity." Piwowar appears to instead be relying on the potential for improved disclosures resulting from several of the initiatives referenced earlier in his remarks so that all investors can access private offerings and make better-informed investment decisions. Piwowar contends that allowing nonaccredited investors to add more "high-risk, high-return" securities in the context of diversified portfolios would permit increased returns without necessarily translating into greater overall portfolio risk.

Piwowar's approach, while interesting and seemingly consistent with President Trump's mandate, raises a number of issues and could create additional risk for issuers. First, the notion that nonaccredited investors could add the kind of "high-risk, high-return" securities presently inaccessible to them without significantly increasing their overall risk profile appears premised on the assumption of portfolio diversification and investors' ability to assess correlation with other investments. Yet given the relatively modest net worth and income thresholds for achieving "accredited investor status imposed by Rule 501 of Regulation D,[1] it would seem that those who cannot satisfy its requirements may also lack the resources to adequately diversify their portfolio at the same time they are investing in these higher-risk securities.

Second, with respect to those nonaccredited investors who do have adequate resources to diversify, Piwowar cannot seriously be suggesting that portfolio diversification would somehow be required as a prerequisite to access to riskier investments. And in the absence of such a requirement (which would be nearly impossible to enforce in any event), many of these investors could be tempted to chase higher yields without a full appreciation of the associated risks. In fact, a report issued by the SEC's Investor Advisory Committee in 2014 expressed a belief that "a significant percentage of individuals who currently qualify as accredited investors are not in fact capable of protecting their own interests." See Recommendation of the Investor as Purchaser Subcommittee and the Investor Education Subcommittee: Accredited Investor Definition at 2.

Furthermore, the notion that improved disclosure would adequately protect these investors seems a debatable proposition. Privately placed securities can often be quite complex financial instruments, or the companies underlying the securities may have relatively poor information availability. Thus, even the best possible disclosure of the features and risks of the investment may have gaps or be beyond the ken of the average investor.

From a litigation perspective, elimination of the distinction between accredited and nonaccredited investors could increase exposure for issuers and underwriters of privately placed securities. When the risks inherent in these "high-risk, high-reward" investments materialize, investors who would not previously have qualified as accredited investors may have a more credible claim that they did not fully understand the disclosure or risks. Such investors may also be more willing to assert that they did not appreciate the risks of the investment than accredited investors. Thus, while Piwowar may view defining accredited investor as "a line-drawing exercise fraught with peril," eliminating the line may be even more perilous.

Ultimately, this seems to be a solution in search of a problem. It is in fact already permissible under several of the Regulation D exemptions to sell securities with just the kind of enhanced disclosure promoted in his comments, or through the appointment of a purchaser representative. The fact that more companies do not take such steps in pursuit of nonaccredited investors is an indication of how they and their counsel feel about the relative benefits of such an approach.

Until the new chairman of the SEC, Jay Clayton, is confirmed, Piwowar's musings are likely to remain just that. From a practical standpoint, requiring substantial new information from companies may actually inhibit capital formation, as the companies most likely to be willing to sell small quantities of securities to unaccredited investors are also those with the least information available, and the costs of providing more complete information would probably outweigh any potential benefits. Therefore, it is likely to be the case that there will be adverse selection bias — those companies most willing to accept investments from unaccredited investors are also likely to be those with the most uncertain prospects.

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[1] $200,000 income for individual or $300,000 for a couple or net worth of greater than $1 million, excluding primary residence.
