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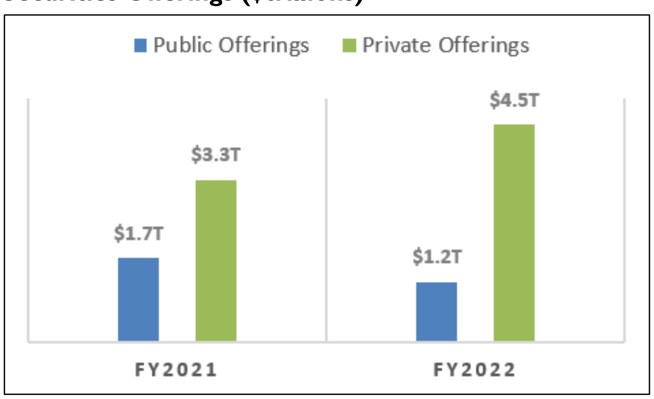
Accredited Investor Definition and Private Securities Markets

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 increases in the volume of private securities offerings. Between July 1, 2021, and June 30, 2022 (FY2022), companies raised roughly $4.5 trillion through private offerings—several times the size of public offerings (**Figure 1**).

Figure 1. New Capital Raised in Public and Private Securities Offerings ($trillions)



Source: CRS using data from SEC Office of the Advocate for Small Business Capital Formation annual reports.

Note: FY = fiscal year ends on June 30. T = $trillions.

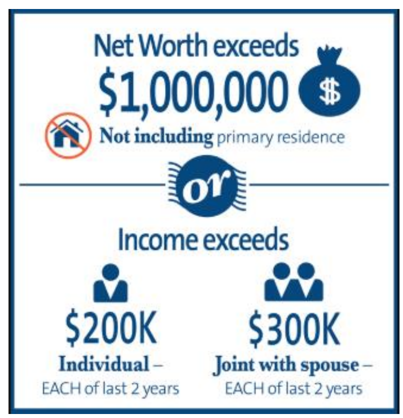
Although private securities offerings are growing in popularity, they also present investors with greater risks than public offerings. Some of these risks derive from private offerings' reduced disclosure relative to public offerings. Without more comprehensive disclosure, investors in private offerings 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 certain 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 Accredited Investor Definition

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

Figure 2. Who Is an Accredited Investor as Measured by Income and Net Worth?



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. Effective December 8, 2020, the SEC expanded the accredited investor definition to include some natural persons with financial expertise, such as (1) individuals with certain financial credentials (e.g., Series 7, Series 65, or Series 82 licenses); (2) "knowledgeable employees" as defined in Rule 3c–5(a)(4) of the Investment Company Act of 1940 (P.L. 76-768), which includes the funds' directors and certain employees involved in investments; and (3) "family clients" of a family office as defined in SEC Rule 202(a)(11)(G). Family offices are entities established by wealthy families to manage their assets and provide other financial services to family members. (For more on family offices, see CRS IF11825.)

Any institutions can qualify as accredited investors if they own more than $5 million in *investments*. Corporations, partnerships, trusts, nonprofits, employee benefit plans, and family offices holding more than $5 million in *assets* could also qualify. Moreover, a number of entities—such as banks, insurance companies, SEC-registered broker-dealers, SEC-registered investment companies, and business development companies—automatically qualify as accredited investors.

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.

- ***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, 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. The percentage of qualifying households had increased to 13% by 2016, according to a separate SEC study.

- ***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.

- ***Financial Stability.*** Some observers believe that with the growth of private securities markets, a significant portion of the overall equity market has become non-transparent to investors and the public. As a result, policymakers and the public have reduced ability to assess the impact of the related activities, potentially affecting policymakers' ability to monitor systemic risk and prevent misallocation of capital.

Proposals to Alter the Accredited Investor Definition

For many years, policymakers, regulators, and industry participants have discussed different ways to change the accredited investor definition, mostly focusing on expanding the definition. 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. The SEC amendments implemented in 2020 reflected several of these proposals.

- ***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).

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