MERCATUS CENTER
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RESEARCH SUMMARY

Abandon the Concept of Accredited Investors in Private Securities Offerings

Private securities offerings have become increasingly popular as more companies wait longer than ever to go public. Their growth has outpaced that of public offerings so much that in recent years more capital has been raised from private offerings than public ones. Private offerings are particularly attractive to investors looking to invest in growing private companies such as early-stage tech startups. As the name implies, securities sold in private offerings are not sold to the general public but almost exclusively to supposedly financially sophisticated entities and individuals known in the world of federal securities law as accredited investors.

In "Abandon the Concept of Accredited Investors in Private Securities Offerings," Andrew N. Vollmer explores the history and basis for the accredited investor category in Rule 506 of the Securities and Exchange Commission's (SEC's) Regulation D. He makes the case that it is time to abandon the concept of accredited investors and open up private offerings to all investors.

REASONS TO ELIMINATE THE ACCREDITED INVESTOR CATEGORY

The benefits of eliminating the accredited investor category far outweigh the benefits of the current system. Costs and problems with the current accredited investor category include the following:

- *It's exclusionary*. Most retail investors are categorized as non-accredited and are essentially shut out from most private offerings, limiting their ability to invest in startups during their highest-growth phase, especially as more companies are remaining private for longer.
- *It's badly conceptualized.* The accredited investor concept is part of a regulatory safe harbor to give definiteness to an exemption from the elaborate registration process for public offers. The exemption depends on a person's actual knowledge of or access to the information that a company would disclose in a public offer. Over time, the definition of an accredited investor expanded and changed and now is not closely correlated with whether a person has information or access to it.
- *It's poorly implemented.* Not all individuals and entities that satisfy the current accredited investor definition meet the financial sophistication criteria of the SEC's standard. For instance, the SEC's income and wealth tests for natural persons are ineffective ways of distinguishing persons who understand the risks of buying securities. Also, the set of skills necessary to run a partnership or corporation is entirely distinct from the ability to evaluate the risks and rewards of a securities investment, yet some partnerships and corporations are included under the current system as accredited investors.
- *It's costly in terms of compliance and oversight*. Issuers in private offerings incur costs to comply with the existing rules to ensure they are only selling to accredited investors, and they are at risk of being embroiled in an enforcement investigation or proceeding if they make a mistake.

- *It infringes upon personal liberty and privacy*. Sorting investors into favored and disfavored classes heightens government intrusion into and control of private decisions and capital allocation.

A NEW APPROACH: OPEN PRIVATE OFFERINGS TO ALL INVESTORS AND MANDATE MINIMAL DISCLOSURES

A different regulatory approach would be better. One better regulatory safe harbor would do the following:

- Eliminate the distinction between accredited and non-accredited investors and open private offerings to all investors.
- Require a minimum level of mandatory disclosures in private offerings. These disclosures should be much more streamlined and shorter than required by other parts of federal securities law to keep private offerings attractive and efficient.

The use of an obligatory disclosure document would return Rule 506 of Regulation D to be much closer to the original understanding in the courts of the statutory private offering exemption. This approach would expand opportunities for investors by allowing all of them to invest in fast-growing private companies and also would provide more sources of capital for businesses. The cost and burden of preparing disclosures should not pose a significant regulatory hurdle to these offerings because evidence from a recent survey of experienced practitioners shows that issuers nearly always already provide some type of disclosure document in private offering transactions.