LOCKE LORD® QUICKStudy
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Stock Offerings and Securities Laws

What Is An Accredited Investor?

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When an emerging business is seeking to raise capital by selling stock or other securities, the term "accredited investor" is likely to come up, so it's helpful to understand why the term is important and what it means.

The Significance of Accredited Investor Status

Offers and sales of securities must comply with federal and state securities laws. Federal law generally prohibits companies from offering to sell securities unless a federal registration statement has been filed with the SEC, and from selling securities unless the registration statement has been declared effective.

Preparing and filing a registration statement is an expensive and time-consuming process, but fortunately federal law provides various exemptions from the registration requirements for specified types of securities and transactions.

Some of the most commonly used exemptions are those found in Regulation D, which is a series of rules adopted under the federal Securities Act of 1933. Regulation D currently consists of nine rules (Rules 500 through 508) establishing three different exemptions from the federal registration requirements. Rules 504, 505 and 506 contain the substantive exemptions.

The term "accredited investor" has three important implications under Regulation D. First, accredited investors are excluded from the calculation of the maximum number of purchasers under the Rule 505 and Rule 506 exemptions. Second, the requirements for information to be disclosed by an issuer under Rules 505 and 506 are different for accredited and non-accredited investors. Third, the prohibition against general solicitation and general advertising does not apply to offers and sales of securities made in accordance with Rule 506, if the purchasers of the securities are accredited investors.

Accredited Investor Defined

An "accredited investor" is any person or entity who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person or entity:

- Any bank as defined in §3(a)(2) of the Securities Act, or any savings and loan association or other institution as defined in Securities Act §3(a)(5)(A);
- Any broker or dealer registered under §15 of the Securities Exchange Act;
- Any insurance company as defined in §2(a)(13) of the Securities Act;
- Any investment company registered under the Investment Company Act;
- Any business development company as defined in §2(a)(48) of the Investment Company Act;
- Any Small Business Investment Company licensed by the U.S. Small Business Administration under §301(c) or (d) of the Small Business Investment Act;

- Any employee benefit plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, with plan assets exceeding $5 million;
- Any employee benefit plan within the meaning of the Employee Retirement Income Security Act meeting one of the following requirements: (1) the investment decision is made by a plan fiduciary which is either a bank, savings and loan association, insurance company, or registered investment adviser; (2) the plan has total assets exceeding $5 million; or (3) if the plan is self-directed, investment decisions are made solely by persons that are accredited investors;
- Any private business development company as defined in §202(a)(22) of the Investment Advisers Act;
- Any charitable organization described in §501(c)(3) of the Internal Revenue Code with total assets exceeding $5 million;
- Any corporation, business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets exceeding $5 million;
- Any director, executive officer, or general partner of the issuer (or any director, executive officer, or general partner of a general partner of the issuer);
- Any natural person whose individual net worth or joint net worth with his or her spouse exceeds $1 million, or who had an individual income of over $200,000 or joint income with his or her spouse of over $300,000 in each of the two most recent years, and who reasonably expects to reach the same income level in the current year;
- Any trust with total assets exceeding $5 million, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Regulation D Rule 506(b)(2)(ii); and
- Any entity in which all of the equity owners are accredited investors.

In determining whether an investor's individual net worth, or joint net worth with his or her spouse, exceeds $1 million, the value of the investor's primary residence must be excluded. Indebtedness secured by the investor's primary residence, up to the estimated fair market value of the primary residence, is not included as a liability, except if the amount of the indebtedness outstanding at the time of the purchase of securities in the offering exceeds the amount outstanding 60 days before that time, other than as a result of the acquisition of the primary residence, the amount of the excess must be included as a liability. This is intended to prevent manipulation of the net worth standard by eliminating the ability of investors to artificially inflate net worth by borrowing against home equity shortly before participating in a securities offering. In addition, any indebtedness secured by an investor's primary residence in excess of the property's estimated fair market value is treated as a liability.

It's worth noting that the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC, at least once every four years after July 21, 2014, to review the definition of "accredited investor" as it applies to natural persons, and authorizes the SEC to adjust the definition (including the $1 million net worth threshold) through rulemaking procedures, as the SEC deems appropriate for the protection of investors, in the public interest, and in light of the economy.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the following attorneys:

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