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July 2013

# SECURITIES AND EXCHANGE COMMISSION

## Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered

# GAO Highlights

Highlights of [GAO-13-640](#), a report to Congressional Committees

## Why GAO Did This Study

Accredited investors who meet certain income and net worth thresholds may participate in unregistered securities offerings. GAO determined that the intended purposes of the accredited investor standard are to (1) protect investors by allowing only those who can withstand financial losses access to unregistered securities offerings and (2) streamline capital formation for small businesses. To qualify as accredited, SEC requires an investor to have an annual income over \$200,000 (\$300,000 for a married couple) or a net worth over \$1 million, excluding a primary residence. The thresholds were set in the 1980s and 2010. The Dodd-Frank Wall Street Reform and Consumer Protection Act mandates GAO to study the criteria for qualifying individual investors as accredited.

This report examines market participants' views on (1) the existing criteria for accredited investor status and (2) alternative criteria. To address these objectives, GAO conducted a literature review, examined relevant data, and interviewed domestic and foreign regulators and industry representatives to identify alternative criteria. GAO also conducted structured interviews of 27 market participants (including broker-dealers, investment advisers, attorneys, and accredited investors).

## What GAO Recommends

SEC should consider alternative criteria for the accredited investor standard. For example, participants with whom GAO spoke identified adding liquid investments and use of a registered adviser as alternative criteria. SEC agreed with GAO's recommendation.

View [GAO-13-640](#). For more information, contact A. Nicole Clowers at (202) 512-8678 or [clowersa@gao.gov](mailto:clowersa@gao.gov)

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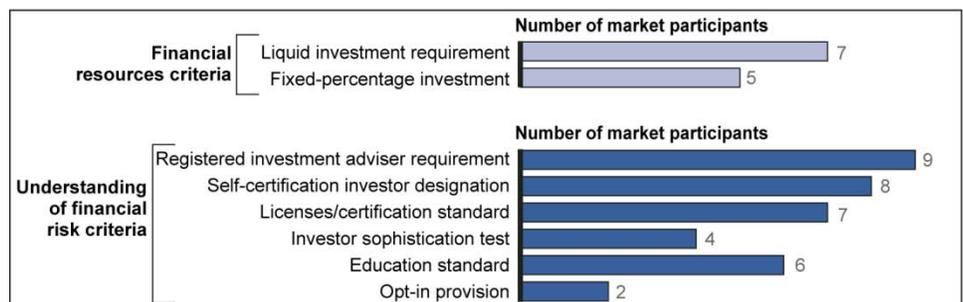
## Alternative Criteria for Qualifying As an Accredited Investor Should Be Considered

### What GAO Found

Of the existing criteria in the Securities and Exchange Commission's (SEC) accredited investor standard, many market participants identified net worth as the most important criterion for balancing investor protection and capital formation. For example, two market participants said the net worth criterion, more so than income, likely indicates the investors' ability to accumulate wealth and their investment knowledge. Others noted that some parts of the market might not accept adjustments to the thresholds. For example, an association of angel investors—accredited investors who invest in start-up companies—told GAO that they would be resistant to increased thresholds because it would decrease the number of eligible investors. GAO analysis of federal data on household net worth showed that adjusting the \$1 million minimum threshold to approximately \$2.3 million, to account for inflation, would decrease the number of households qualifying as accredited from approximately 8.5 million to 3.7 million.

While citing net worth as the most important criterion, several market participants GAO interviewed said that alternative criteria related to an investor's liquid investments and their use of an investment adviser also could balance investor protection and capital formation. GAO obtained views on eight alternative criteria that focus on investors' financial resources and their understanding of financial risk—criteria that SEC or industry groups previously proposed or that foreign regulators use. Among the financial resources criteria, market participants with whom GAO spoke most often identified a liquid investments requirement—a minimum dollar amount of investments in assets that can be easily sold, are marketable, and the value of which can be verified—as the most important for balancing investor protection and capital formation. Among the understanding financial risk criteria, market participants most often identified the use of a registered investment adviser. Beginning in 2014, SEC must review the accredited investor definition every 4 years to determine whether it should be adjusted. This study provides a reasonable starting point for SEC's review. Specifically, SEC will have the views of market participants about how existing and alternative qualifying criteria could help determine an investor's ability to bear and understand risks associated with unregistered securities offerings.

### Market Participants' Views on Which Alternative Criteria Best Balance Investor Protection and Capital Formation



Source: GAO analysis of structured interviews.

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### Abbreviations

AAll	American Association of Individual Investors
ACA	Angel Capital Association
IAA	Investment Adviser Association
JOBS Act	Jumpstart Our Business Startups Act
NASAA	North America Securities Administrators Association
PIPE	Private Investment in Public Equity
SCF	Survey of Consumer Finances
SEC	Securities and Exchange Commission
NVCA	National Venture Capital Association

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July 18, 2013

The Honorable Tim Johnson  
Chairman  
The Honorable Michael Crapo  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Jeb Hensarling  
Chairman  
The Honorable Maxine Waters  
Ranking Member  
Committee on Financial Services  
House of Representatives

Small businesses rely on capital to start and expand their businesses. Some small businesses often satisfy capital needs by asking friends and family members, or by seeking bank loans. Small businesses (like start-up companies) that exceed these resources, or have additional capital needs, may seek to sell shares of ownership or securities convertible into shares of ownership in the business to raise needed cash to be used in operations. Businesses and public companies can seek capital through public offerings or nonpublic offerings (private placements).

The Securities Act of 1933 (Securities Act) requires companies that are publicly offering securities for investment to register the offering of the securities with the Securities and Exchange Commission (SEC) and provide investors with all material information necessary to make an investment decision.<sup>1</sup> The Securities Act contains exemptions from registration and authorizes SEC to provide, by rule, additional exemptions.

In particular, Rule 506 under SEC Regulation D exempts offerings from registration if the issuer conducts a limited offering and restricts sales to accredited investors and up to 35 nonaccredited investors. Within Regulation D, SEC sought to facilitate capital formation while protecting

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<sup>1</sup>17 C.F.R. 230.408.

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investors—consistent with its mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital. While Regulation D originated as an effort to assist small businesses with capital formation, various types of companies rely on registration exemptions in Regulation D. According to SEC staff, in 2011, the estimated amount of capital raised in these types of exempt offerings was just over \$1 trillion, which is comparable to the amount of capital raised in registered offerings in that year. Further, pooled investment vehicles (hedge fund, private equity, venture capital, and other investment funds) are among the top issuers under Regulation D, accounting for 29 percent of such offerings in 2011.<sup>2</sup>

Under Regulation D, SEC defines individual accredited investors as meeting certain income and net worth thresholds.<sup>3</sup> Based on information we reviewed, this type of investor is generally a securities purchaser who possesses knowledge and experience in finance and business matters to evaluate the risks and merits of prospective investments or one who the issuer reasonably believes meets this description.<sup>4</sup> On the basis of the legislative history of the accredited standard, SEC’s mission statement, and academic literature, we determined that the intended purposes of the accredited investor standard are to protect investors (by allowing only those who can withstand financial losses to have access to private placements) and streamline capital formation for small businesses. SEC’s thresholds for individual accredited investors were established in the 1980s. The thresholds for income and net worth were intended as a buffer to protect the investor from potential economic loss of investing in private placements. Section 415 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires us to study appropriate criteria for qualifying as an accredited investor.

This report examines market participants’ views on (1) the existing criteria for qualifying for accredited investor status, and (2) alternative financial

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<sup>2</sup>Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption*, report prepared for SEC, Division of Risk Strategy and Financial Innovation (Washington, D.C.: Feb. 2012).

<sup>3</sup>The focus of this report is on individual accredited investors and not the institutional or non-natural person accredited investor. As a result, in this report we refer to natural person accredited investor as “accredited investor.”

<sup>4</sup>As will be discussed later in this report, SEC does not track the number of accredited investors and the total population of this type of investor is unknown.

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and other qualification criteria. To address these objectives, we reviewed SEC's current definition of and legislative history for the accredited investor standard. We also reviewed SEC's proposed changes to the accredited investor standard since 2006, market participants' comment letters to SEC on these proposals, academic literature related to accredited investors and unregistered securities offerings, and applicable criteria used by foreign regulators. To estimate the impact of changing the minimum net worth and income thresholds on eligible households, we analyzed data from the Survey of Consumer Finances (SCF) issued by the Board of Governors of the Federal Reserve System (Federal Reserve). We found the Federal Reserve data to be sufficiently reliable to evaluate household income and net worth levels. We interviewed staff from SEC and other federal financial regulators, lawyers knowledgeable about accredited investor issues, and trade associations to discuss current and alternative criteria for accredited investor status. In addition, we interviewed officials from the Ontario (Canada) Securities Commission and United Kingdom Financial Services Authority about their investor standards, and others with standards similar to the U.S. accredited investor standard.

Compiling information from SEC's proposed changes, academic literature, and criteria used by foreign regulators, we identified eight alternative criteria. We grouped these criteria under two categories—financial resources and understanding financial risk. To obtain the views of market participants on existing and alternative criteria, we conducted structured interviews with a judgmental sample of 27 market participants, whom we categorized in four groups of different segments of the accredited investor population: (1) attorneys who have experience in private placement transactions, (2) accredited investors who invest in private placements, (3) retail investors who meet the current accredited investor criteria but do not necessarily invest in private placements, and (4) broker-dealers and investment advisers who work with accredited investors. The results from the structured interviews are not generalizable to the population of market participants and only represent the opinions of these 27 individuals. See appendix I for additional information on our scope and methodology.

We conducted this performance audit from June 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

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the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

Small businesses, such as startup companies, may choose to raise capital through a nonpublic offering, also called a private placement, when their capital needs exceed what might be available through other channels (such as bank loans, personal credit cards, or loans from friends and family).<sup>5</sup> Public companies also may raise capital using private placements to benefit from lowered transaction costs and raise funds more quickly than in the public market.<sup>6</sup>

Private placements generally involve issuers, placement agents or finders, qualifying accredited investors, and regulators.

- **Issuers.** Issuers include private and public companies, and pooled investment vehicles such as hedge, venture capital, or private equity funds.<sup>7</sup>
- **Placement agent or finders.** Issuers may employ placement agents (who are registered with SEC, the Financial Industry Regulatory Authority, or states) and finders (who are unregistered with regulators) to access accredited or other qualified investors.<sup>8</sup>
- **Qualifying accredited investors.** Qualifying accredited investors can be individuals or institutions. Some individual accredited investors, called angel investors, invest in early-stage start-up companies with high growth potential. Other qualifying accredited investors, such as venture capital funds that invest in start-ups at later stages of development, are institutional accredited investors.

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<sup>5</sup>We use the term “start-up companies” to refer to small businesses with a scalable business model. In interviews we conducted, market participants told us that start-up companies generally connote businesses with high growth potential.

<sup>6</sup>Using Private Investment in Public Equity (PIPE) transactions, public companies sell securities to a limited group of accredited investors in a private transaction and file a registration statement to provide for resale by those investors into public markets.

<sup>7</sup>Pooled investment vehicles accumulate capital from third parties, including individuals and institutional entities such as endowment or pension funds that frequently qualify as accredited investors, and make investments on the third parties' behalf.

<sup>8</sup>Qualified purchasers and qualified clients are separate categories of investors in some types of private placements of pooled investment vehicles under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, respectively. The qualifying criteria for such investors differ from those for accredited investors.

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- **Regulators.** SEC and state regulators have some oversight over the offering and sale of private placement securities. SEC generally limits its enforcement activity to fraud and does not conduct reviews of offering materials or verify accredited investor status.<sup>9</sup> State regulators play a role in investigating potential fraud in private placements and enforcement after the securities have been sold in their state for certain exempted securities.

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## Regulation D

Regulation D defines accredited investors and describes certain terms and conditions of offers and sales of private placements securities.<sup>10</sup> Under Regulation D, accredited investors consist of institutional entities and individuals. Institutions that qualify as accredited investors include certain regulated financial institutions and certain entities with total assets of \$5 million or more.<sup>11</sup> Individuals who qualify as accredited investors are directors, executive officers, and general partners of the securities issuers, or persons who have a minimum annual income in excess of \$200,000 (\$300,000 with spouse) or net worth in excess of \$1 million excluding primary residence (see fig. 1). The focus of this report is on individual accredited investors.

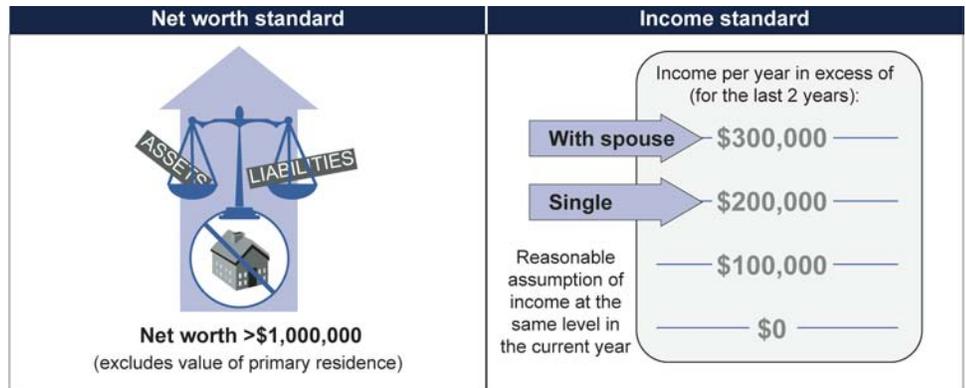
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<sup>9</sup>SEC officials said that for Regulation D, if the issuer did not comply with applicable securities laws, generally investors would have a right of rescission on their investments, which provides an incentive to issuers for ensuring their investors meet the accredited investor standard.

<sup>10</sup>See appendix II for more information on requirements for exemption under Regulation D rules.

<sup>11</sup>Regulated financial institutions include banks, savings and loan institutions, registered brokers and dealers, insurance companies, registered investment companies, and Small Business Investment Companies. Qualifying entities with more than \$5,000,000 in assets include certain benefit plans, 501(c) (3) organizations, corporations, and trusts not formed for the purpose of acquiring the offered securities whose purchase is directed by a sophisticated person.

**Figure 1: Net Worth and Income Standards for Individual Accredited Investors, as of July 2013**



Source: SEC; Art Explosion.

Regulation D establishes registration exemptions, with the exemptions differing in the size of offerings, the number and type of investors, or both. These exemptions are described in Rules 504, 505, 506.

- Under Rule 504, the maximum dollar amount of the offering is \$1 million in any 12-month period and no limit is set on the number of investors.
- Under Rule 505, the maximum offering is \$5 million in any 12-month period and unlimited number of accredited investors and up to 35 nonaccredited investors may invest.
- Under Rule 506, there are no offering dollar limits and an unlimited number of accredited investors and up to 35 nonaccredited sophisticated investors may invest.

Offerings made in reliance on the rules cannot solicit investors through any form of general solicitation or general advertising.<sup>12</sup> SEC staff has indicated that an issuer would not contravene the prohibition against general solicitation if the issuer had a preexisting and substantive

<sup>12</sup>On July 10, 2013, the SEC adopted a final rule permitting issuers using Rule 506 to utilize general solicitation and advertising when all the purchasers are accredited investors. The prohibition on general solicitation and advertising remains in effect for Rule 504 and 505 offerings, and Rule 506 offerings with purchasers who are not accredited investors.

relationship with the investor.<sup>13</sup> Of the three rules, Rule 506 is the most widely used exemption because there is no limit on the size of the offering or the number of accredited investors.<sup>14</sup> Further, according to a GAO report, complying with state securities registration requirements for other exemptions may play a role as to why issuers rely more on Regulation D.<sup>15</sup>

SEC data show that businesses make more Regulation D offerings than registered public offerings (see table 1).<sup>16</sup> Regulation D is designed to (1) eliminate any unnecessary restrictions SEC rules place on small business issuers, and (2) achieve uniformity between state and federal exemptions to facilitate capital formation consistent with investor protection.<sup>17</sup>

**Table 1: Number of Regulation D and Registered Public Offerings Filed, Fiscal Years 2009-2012**

Type of securities offering	2009	2010	2011	2012
Regulation D	17,887	17,178	18,203	18,107
Registered public offering	5,855	6,486	6,347	5,803

Source: SEC data.

Notes: Data for Regulation D offerings include new SEC Form D filings, and not amendments. Regulation D data include notices for exemptions under Rules 504, 505, and 506. Regulation D data for 2009 are based on the number of paper filings received and data for 2010 onward are based on electronic Form D filings. Registered public offerings include all original registration statements filed by issuers on Forms F-1, F-3, F-4, F-7, F-8, F-10, F-80, S-1, S-3, S-4, S-6, S-8, S-11, S-20, N-1A, N-2, N-3, N-4, N-5, N-6, and N-14, and not amendments. The F-series registration forms are available only to foreign private issuers, the S-series registration forms generally are available to domestic issuers, and the N-series registration forms are available to investment companies.

<sup>13</sup>Rule 504 allows issuers to use a general solicitation under certain circumstances, including when offers and sales are registered in states that require the filing of a substantive disclosure document or if the state permits general solicitation and advertising only to accredited investors.

<sup>14</sup>SEC analysis of information extracted from all electronic Form D filings from January 2010 – March 2011 illustrates the dominant use of Rule 506 (in comparison with Rules 504 and 505). For the three rules, approximately 55 percent of issuers filed under 506, and approximately 21 percent and approximately 18 percent, respectively, filed under 504 and 505. See Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption*, report prepared for SEC, Division of Risk Strategy and Financial Innovation.

<sup>15</sup>GAO, *Securities Regulation: Factors That May Affect Trends in Regulation A Offerings*, [GAO-12-839](#) (Washington, D.C.: July 3, 2012).

<sup>16</sup>Ivanov and Bauguess, “Capital Raising in the U.S.”

<sup>17</sup>[GAO-12-839](#).

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## Past, Recent, and Proposed Changes to the Accredited Investor Standard and Regulation D

The accredited investor standard, which is used to adjust exemptive conditions under Regulation D, has undergone several changes since its adoption in 1982. As shown in figure 2, the qualifications for investment in private placements securities went through several interpretations and changes. For example, in 1953 the Supreme Court ruled that the applicability of registration exemptions depended on whether the purchasers of securities could “fend for themselves.”<sup>18</sup> In 1974, SEC adopted Rule 146, a predecessor to Rule 506, which stated that investors were financially sophisticated enough to be offered or purchase private placement securities based on their knowledge and experience, capability of evaluating the risk and merits, and ability to bear the economic risk of investment.<sup>19</sup> In 1982, Regulation D—the goals of which included facilitating capital formation and promoting investor protection—replaced previous rules, including Rule 146. The income and net worth thresholds established in Regulation D were intended to serve as proxies for financial experience, sophistication, and adequate bargaining power.<sup>20</sup> Since 1982, SEC twice revised the individual accredited investor standard: it added the \$300,000 threshold for joint income in 1988, and excluded the value of primary residence as part of the net worth calculation in 2011 as required by the Dodd-Frank Act.<sup>21</sup>

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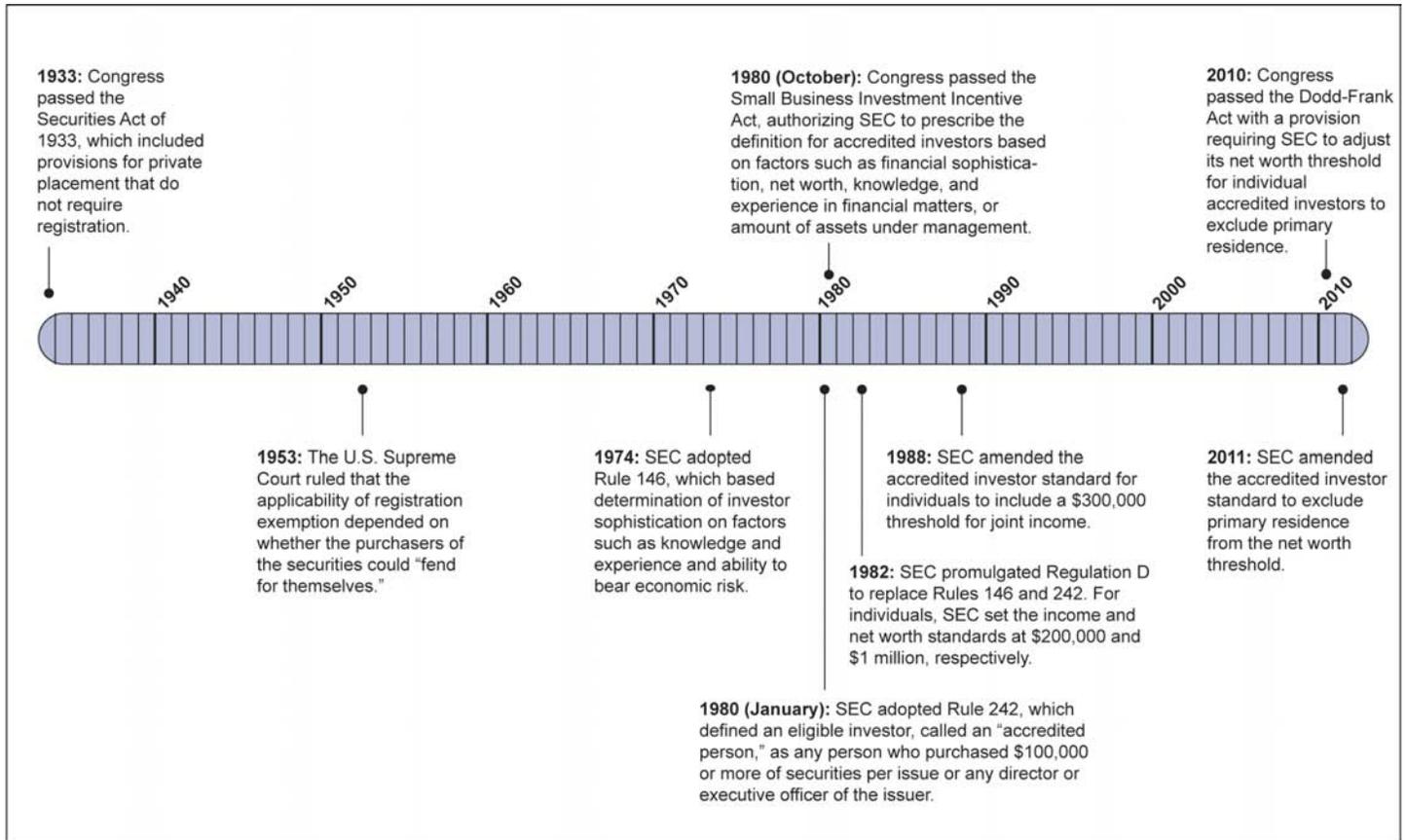
<sup>18</sup>SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

<sup>19</sup>For this determination, important considerations were whether the investor could afford to hold unregistered securities for an indefinite period of time and whether at the time of the investment the investor could afford a complete loss. Additionally, the issuer should have reasonably believed that the investor, in combination with any representative, had the knowledge and experience in financial and business matters and that he or she was capable of utilizing information the rule requires to be provided to the investor to evaluate risks of the investment. Part 230 – General Rules and Regulations, Securities Act of 1933; Transactions by an Issuer Deemed Not to Involve Any Public Offering, 39 Fed. Reg. 15261 (May 2, 1974). Transactions by an Issuer Deemed Not to Involve Any Public Offerings: Revision of Proposal, 38 Fed. Reg. 28951, 28954 (Oct. 18, 1973).

<sup>20</sup>Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 For Transactions Involving Limited Offers and Sales, 46 Fed. Reg. 41791 (Aug. 18, 1981).

<sup>21</sup>Regulation D Revisions, 53 Fed. Reg. 7866 (Mar. 10, 1988). Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81793 (Dec. 29, 2011).

**Figure 2: History of the Accredited Investor Standard for Individuals, 1933-2011**



Source: GAO.

In recent years, market participants and a regulator have proposed several changes to the accredited investor standard for individuals. The proposals were generally based on concerns for investor protection and capital formation, and consist of adjustments to income and net worth and alternative ways of measuring investor knowledge. For instance, two consumer advocacy groups, an investment company association, SEC, and North American Securities Administrators Association (NASAA) have expressed concerns that the number of those eligible to be accredited investors has grown significantly since the thresholds were established. According to SEC, when the standard was first created, 1.87 percent of households qualified as accredited investors. SEC staff estimate that 9.04 percent of households would have qualified as accredited investors under the net worth standard in 2007; we estimate that removing the primary residence from households’ net worth, as required in the Dodd-Frank Act,

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dropped the percentage to 7.2 percent (based on 2010 data).<sup>22</sup> SEC and NASAA say that because private placement offerings are generally illiquid, complex, and not reviewed by state or federal regulators, the risks of investing in private placement offerings are high and a higher level of protection may be necessary to protect accredited investors. In contrast, the angel investor community has expressed concerns about how any proposed changes could affect capital formation for start-up companies.

Noting concerns about investor protection, SEC proposed several changes to Regulation D during the 2000s. In December 2006, SEC proposed a new standard for individuals with the goal of providing additional protection to accredited investors investing in certain pooled investment funds, including hedge funds. An investor would have to meet either the existing income or net worth criteria and also own at least \$2.5 million in investments at the time of the purchase of the securities. SEC stated that with this proposal, it sought to ascertain that an individual likely would have sufficient knowledge and experience to evaluate the merit and risk of certain private placement investments or be able to hire someone able to do so. In their comment letters on this proposal, some market participants suggested that SEC adjust the income and net worth standards for inflation, while others suggested these standards be lowered or eliminated. Some commentators suggested that SEC use a percentage of the net worth standard for certain investments. Others agreed with the proposal but made suggestions such as decreasing the required investments owned. This proposal was never finalized because, according to SEC officials, it received competing demands and mixed comments during the comment period.

In July 2007, SEC proposed other changes to align its rules with modern market practices and communications technologies without compromising investor protection. First, SEC proposed to create a new exemption for offers and sales for a new category of investors to be designated as “large accredited investors.” Under this standard, individuals would have to own \$2.5 million in investments or have an annual income of \$400,000 (or \$600,000 for married couples). Second, SEC proposed an alternative

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<sup>22</sup>Based on 2010 data, we estimate that 5.2 and 2.8 percent of households would have qualified under the existing income threshold (individual and couple, respectively). We used 2010 year-end data from the Federal Reserve’s Survey of Consumer Finances, the latest data available, and SEC staff used 2007 data because they were the latest data available.

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criterion for the accredited investor standard (to include \$750,000 of investments owned) and adjusting the dollar-amount thresholds for investments owned, income, and net worth to reflect future inflation. According to SEC, it did not finalize its proposals due to, as stated before, competing demands and the mixed comments it received during the comment period.<sup>23</sup>

There are pending changes to Regulation D as a result of the passage of the Dodd-Frank Act and the Jumpstart Our Business Startups Act (JOBS Act).

- First, Section 926 of the Dodd-Frank Act directs SEC to adopt a rule that would make the Rule 506 exemption unavailable to securities offerings in which “felons or other bad actors” were involved. SEC proposed a rule in 2011 defining bad actors and prohibiting them from using the Rule 506 exemptions if they have been convicted of, or are subject to court or administrative sanctions for securities fraud or other violations of specific laws.<sup>24</sup> The SEC commission adopted the final rule in July 2013 which prohibits bad actors, which include the issuer, certain issuer, officers, significant owners, general partners or managing members of the issuer, whose actions occurred after the rule’s effective date from using Rule 506.<sup>25</sup> Actions which occurred before the effective date must be disclosed but do not act as a prohibition against using Rule 506.
- Second, the Dodd-Frank Act also requires SEC to review the “accredited investor” definition in its entirety beginning in 2014 and every 4 years thereafter and to conduct rulemaking as SEC deems appropriate after each review. As a result, criteria within the standard could change. According to SEC officials, they are conducting their review of the entire definition in 2014, after we publish our report on

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<sup>23</sup>On July 10, 2013, the SEC released a proposed rule which, in part, requested comments regarding the definition of accredited investor including on whether the net worth and income tests are the appropriate tests, whether the current financial thresholds are appropriate or should be indexed to inflation, and whether the thresholds should be tied to something other than a fixed dollar amount. The SEC did not include proposed language changes to the definition.

<sup>24</sup>SEC proposed similar amendments in 2007 but, according to SEC officials, it did not take final action on that proposal because of competing demands and the mixed comments it received during the comment period.

<sup>25</sup>The final rule was adopted by the commissioners on July 10, 2013 and takes effect 60 days after publication in the Federal Register.

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market participants' views relating to existing and alternative criteria for qualifying as accredited.

- Third, the JOBS Act directs SEC to implement a rule that would permit companies to use general solicitation and advertising to offer securities under Rule 506 of Regulation D. In August 2012, SEC proposed a rule permitting companies to advertise and market such securities offerings provided that the issuer takes reasonable steps to verify the purchaser's accredited investor status. Currently, Rule 506 does not specifically require that the issuer verify that accredited investors meet the requirements. The comment period to the proposed rule closed in October 2012. On July 10, 2013, the SEC adopted the final rule which permits issuers using Rule 506 to utilize general solicitation and advertising when all the purchasers are accredited investors.<sup>26</sup>

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## Net Worth Identified as Most Important Criterion for Qualifying as Accredited Investor

Among existing criteria, market participants whom we interviewed said a net worth criterion was most important for balancing the goals of protecting investors and facilitating capital formation.<sup>27</sup> While market participants offered varying viewpoints on how adjusting the existing thresholds for net worth and income would impact investor protection, they tended to agree on how adjustments would impact capital formation. In particular, many argued that increasing the thresholds would limit capital formation. Our analysis of Federal Reserve consumer finance data indicates that increasing the existing thresholds would contribute to limiting the pool of the eligible investors. Market participants said

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<sup>26</sup>The final rule is effective 60 days after the rule is published in the Federal Register. As of July 11, 2013, it has not been published in the Federal Register. Additionally, on July 10, 2013, the SEC proposed a rule which would mandate additional requirements of issuers using the new general solicitation and advertising provisions, including requiring those issuers to file certain mandatory paperwork before the issuer engages in the general solicitation, requiring written general solicitation materials used in the new offering type to include certain disclosures, and imposing temporary submission requirements for general solicitation materials.

<sup>27</sup>We conducted structured interviews with a judgmental sample of 27 market participants that we selected with assistance from their industry associations' leadership and their peers. The results from the structured interviews are not generalizable to the population of market participants and only represent the opinions of these 27 individuals. We compared response patterns between the four types of market participants that we interviewed and found that generally, there were little differences in those patterns. By response pattern we mean the variability in response options chosen. See appendix I for additional information on our scope and methodology and appendix III for structured interview results.

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adjusting the existing net worth and income criteria is feasible, but market acceptance would depend on the extent of the adjustments.<sup>28</sup>

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### Market Participants Said Net Worth Best Balances Goals of Investor Protection and Capital Formation

Seventeen of 27 market participants said that net worth was the most important criterion for balancing investor protection and capital formation.<sup>29</sup> Nine of the 17 market participants said that net worth alone was the key criterion for balancing investor protection and capital formation. The other 8 participants stated that net worth with other criteria was important to balance investor protection and capital formation. Two market participants told us that net worth demonstrated an investor's ability to accumulate wealth over time. One market participant also thought it indicated an investor's understanding of financial risk and having experience with investment decisions. A few market participants and an industry expert said that a high net worth provided a cushion against risky investments—that is, having enough assets to bear the loss of the investment should a start-up company fail. However, representatives from an industry association and a broker-dealer firm cautioned that net worth is not easily identifiable or verifiable because they have to rely on information from the investor. For example, net liabilities—a component of net worth—are a complex measure to calculate and net worth can be subject to manipulation.

Of the two existing qualifying criteria, most market participants did not think income was the best criterion to balance investor protection and capital formation. One of the 27 market participants identified income alone as the most important criteria. However, one market participant said that it was more probable that an investor's income could decline compared with net worth, and net worth tended to be a better indicator than income of an investor's knowledge of the markets. For example, a wealthy professional would not necessarily have a guarantee that his or

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<sup>28</sup>We defined market acceptance as the willingness of the current marketplace and any new market players established by the proposed change to accept the new accredited investor qualification.

<sup>29</sup>We asked market participants to rate the importance of existing and alternative criteria (for financial resources and understanding of financial risk). Some respondents said more than one criterion was the most important. As a result, for each criterion, we counted all instances in which the respondent identified a criterion as important. Therefore, totals may not add to 27. See appendix I for additional information on our scope and methodology and appendix III for structured interview results.

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her income would remain the same or have the investment experience or financial wherewithal, depending on his or her profession, to invest in private placements. Nonetheless, an athlete or a doctor, for example, will qualify under the income standard, but it is unclear whether he or she could afford to hold the private placement for an indefinite period and whether he or she could afford a complete loss.

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### Views on Potential Implications for Investor Protection and Capital Formation of Adjusting Net Worth and Income Thresholds

Market participants had differing opinions on whether the thresholds for the existing criteria should be adjusted, citing various advantages and disadvantages associated with balancing investor protection and capital formation. Some market participants (13 of 27) said the thresholds should be adjusted, two believed that the current thresholds should be increased, but differed on how much they should be increased. To better protect investors, some participants thought the levels should be increased to adjust for inflation—thus focusing on the original subset of the population that was targeted when the standards were first implemented. For example, officials from one industry group said that SEC designated the existing thresholds to identify a subset of the population that does not need SEC’s regulatory investor protection and therefore the thresholds should be readjusted periodically to ensure that the thresholds only capture the intended population. Others suggested the thresholds are very outdated and should be raised even higher than inflation.

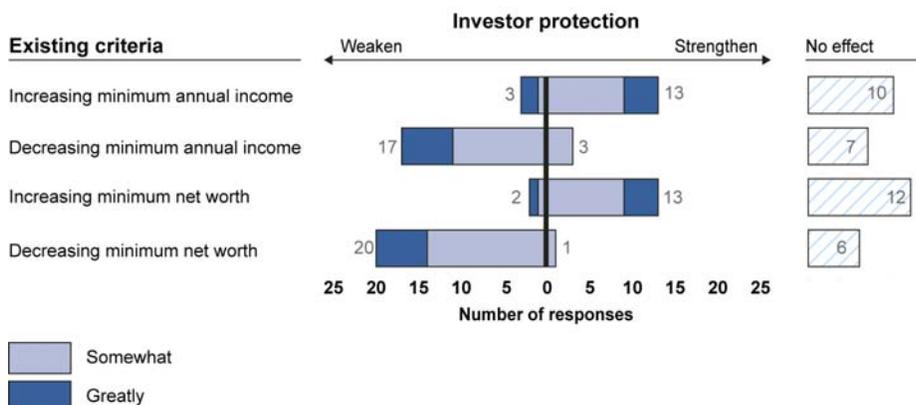
However, almost an equal number of market participants (11 of 27) said the current thresholds should not be adjusted. For example, a number of participants commented that the net worth threshold already had been significantly adjusted because the primary residence is no longer considered as part of the net worth calculation. In addition, officials from an investor association said that regulators should take into account regional differences when considering changes to the thresholds as they represent a significant dollar amount in certain states with lower average income levels. Thus, adjusting the existing criteria could negatively affect some regions more than others. For example, in a rural state increased thresholds could negatively affect investors’ ability to qualify under the standard and make it harder for local start-up companies to seek investors and capital inside the state, according to an investor association.

Market participants had differing views on the impact of increasing the thresholds on investor protection (see fig. 3). Some thought that investor protection would be strengthened, and a similar number responded that

increasing the current qualification criteria would have no effect on investor protection.

- Thirteen of the 27 individuals we interviewed said that increasing the minimum annual income requirement would strengthen investor protection. Ten of the 27 said it would have no effect, 3 said it would weaken, and 1 said they did not know.
- Similarly, 13 of the 27 market participants said that increasing the minimum net worth requirement would strengthen investor protection. Twelve said it would have no effect and 2 said it would weaken.

**Figure 3: Market Participants’ Opinions on How Existing Criteria Would Affect Investor Protection, as of February-March 2013**



Source: GAO analysis of structured interviews.

Notes: We asked market participants if a change to the existing criteria would strengthen, weaken, or have no effect on investor protection. We then asked those who responded that a change would strengthen or weaken protection if the proposed change would greatly or somewhat strengthen (or weaken) investor protection. One market participant refused to answer on how increasing minimum annual income would affect investor protection.

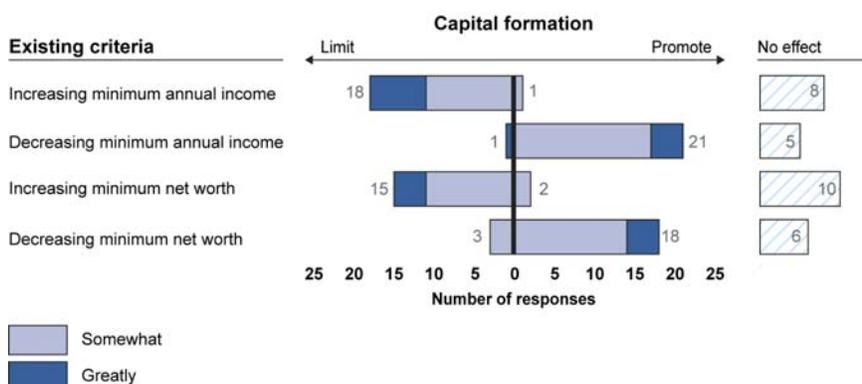
Investor and industry associations that we interviewed separately did not support adjusting the thresholds of the existing criteria to increase investor protection. An investor association and an academic acknowledged the importance of establishing thresholds to protect investors who may not have the knowledge or ability to protect themselves against making risky investments. Regardless of the thresholds, a representative from an investor association said that its investors completed due diligence on potential investments to protect their financial portfolio. Furthermore, industry associations representing attorneys and financial advisers involved in private placement generally agreed that the current qualification criteria were adequate. They said that

any changes to the thresholds might provide only marginal increases to investor protection.

Market participants' views were more similar on the impact of increasing the income and net worth thresholds on capital formation for businesses (see fig. 4). Specifically, most said that increasing the thresholds would limit capital formation.

- Eighteen of the 27 individuals said increasing the minimum annual income requirement would limit capital formation. Eight of the 27 said it would have no effect and 1 said it would promote capital formation.
- Fifteen of the 27 individuals said increasing the minimum net worth requirement would limit capital formation. Ten said increasing the net worth requirement would have no effect on capital formation and 2 said it would promote it.

**Figure 4: Market Participants' Opinions on How Existing Criteria Would Affect Capital Formation, as of February-March 2013**



Source: GAO analysis of structured interviews.

Note: We asked market participants if a change to the existing criteria would promote, limit, or have no effect on capital formation. We then asked those who responded that a change would promote or limit capital formation if the proposed change would greatly or somewhat strengthen (or weaken) capital formation.

Representatives from associations representing start-up companies and angel investors said that raising the current thresholds would limit capital formation. Specifically, the representatives said that raising the thresholds would reduce the current number of angel investors—a type of accredited investor who invests in start-up companies—and other eligible accredited

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investors.<sup>30</sup> A representative of a venture capital association told us that removing the primary residence from the net worth calculation was a significant adjustment to the current standard and that any further changes would further limit the pool of accredited investors, discourage angel investing, and ultimately hinder the ability of start-up companies to access capital.<sup>31</sup> For instance, a representative of a network of angel investors said that he knew other accredited investors in the network who no longer qualified because of the 2011 change in the net worth calculation. However, according to an official from the North America Securities Administrators Association (NASAA) and a former regulator, start-up companies have other avenues to access capital such as new or expanded capital formation programs in the JOBS Act.<sup>32</sup> As a result, the officials said that increasing the minimum thresholds would not limit a start-up company's ability to access capital.

According to SEC staff, it does not have a list of accredited investors because maintaining such a list would be impractical because there are so many accredited investors and could raise privacy concerns. If maintaining such a list were possible, the costs of doing so would likely outweigh the benefits. Therefore, determining the potential impact of changes to the existing thresholds on the pool of accredited investors is

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<sup>30</sup>Angel investors are generally accredited investors who invest their own money in a start-up company for an equity share. There are no databases of angel investors and no public records of their investment transactions. As a result, it is difficult to analyze data on the size of investments in start-up companies. According to one study, angel groups invest an average of more than \$300,000 per deal, with an average of from four or five individual investors in each deal, investing an average of \$68,000. One angel investor with whom we spoke said that her Kansas City-based network invested about \$14,000 per investor. Another angel investor in Savannah, Georgia, said that investors in his network typically invested \$25,000 to \$50,000 per deal.

<sup>31</sup>According to representatives from associations and an industry expert, sources of capital can be limited for start-up companies, magnifying the role of angel investors. For instance, one association that represents venture capital funds told us that the venture capital industry has been contracting and not investing in start-up companies. According to a representative from an investor association, many institutional investors no longer invest in venture capital funds because of the economic downturn and weak returns on investment.

<sup>32</sup>For example, Title IV of the JOBS Act increased the cap for Regulation A, an exemption from securities registration, from \$5 million to \$50 million and Title III created "crowdfunding," which involves small businesses seeking funding over the Internet from investors putting up relatively small amounts of capital. However, the rules for Regulation A and crowdfunding have not yet been finalized. For more on Regulation A, see [GAO-12-839](#).

difficult. To estimate such impacts, we analyzed Survey of Consumer Finances data, the data that SEC also uses for these purposes. These data show that changing the thresholds for net worth and income would affect the pool of eligible accredited investors.<sup>33</sup> Specifically, we found that increasing the minimum net worth or income thresholds would decrease the number of eligible household investors. Our analysis of federal household net worth data showed that adjusting the minimum thresholds to account for inflation from \$1 million to approximately \$2.3 million—the inflation adjusted amount—would decrease the number of households qualifying as accredited from approximately 8.5 million to approximately 3.7 million. Table 2 illustrates how further adjusting the thresholds affects the number of eligible investors.

**Table 2: Number of Households Eligible for Accredited Investor Status at Various Thresholds for Net Worth and Income, 2010**

Income threshold		Net worth threshold	
Existing and hypothetical thresholds	Number of households	Existing and hypothetical thresholds	Number of households
\$100,000	21,600,000	\$250,000	23,200,000
\$200,000 (existing for individuals) <sup>a</sup>	6,100,000	\$1,000,000 (existing)	8,500,000
\$300,000 (existing for couples) <sup>b</sup>	3,300,000	\$1,750,000	4,600,000
\$400,000	2,400,000	\$2,500,000	3,400,000
\$500,000	1,700,000	\$3,250,000	2,700,000

Source: GAO analysis of Federal Reserve data.

Notes: The Federal Reserve conducts the Survey of Consumer Finances every 3 years. The most recent data are from 2010. The information collected is based on household data, not individual data. Net worth excludes home equity. The hypothetical thresholds were nominal dollar amounts and not inflation adjusted. The results would be different if we applied current dollars because of inflation and

<sup>33</sup>We analyzed information from the Survey of Consumer Finances, the best publicly available data for our purposes, as proxy data about households that met the current qualification criteria. The Survey of Consumer Finances is a nationally representative survey of households with information on income and net worth. However, there are important limitations to using the Survey of Consumer Finances to estimate the pool of accredited investors. First, the Survey of Consumer Finances data measures the income and wealth of households, not of individuals. In some cases, assets may not be jointly owned within a household. In addition, we could not determine whether households in the Survey of Consumer Finances data have been accredited investors in the past, and we may be overstating the households that might participate in the future. Finally, as with any survey, the issues of nonresponse and sample size affect the reliability of the data.

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changes in the economy. These thresholds were chosen arbitrarily to demonstrate how changing the thresholds could affect the numbers of eligible accredited investors. These estimates are relative to the total number of households represented by the survey, 118 million. In all cases, the confidence intervals associated with these estimates were plus or minus 15 percent of the estimates themselves, or less. For the purposes of this analysis, a household refers to the primary economic unit within a household (to which the Survey of Consumer Finances refers as a family). For more information (including standard errors) see appendix 1.

<sup>a</sup>Existing for individuals” is the annual income threshold for an individual investor as required by SEC.

<sup>b</sup>Existing for couples” is the annual income threshold for a married couple as required by SEC.

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## Views on Feasibility and Market Acceptance of Adjusting Net Worth and Income Thresholds

Market participants with whom we spoke said adjusting the thresholds upward for the existing net worth and income criteria would be feasible, but market acceptance would depend on how much the thresholds were adjusted.

- The majority of market participants (25 of 27) said it would be feasible to increase the income requirements and 24 of 27 said it would be feasible to increase the net worth thresholds.<sup>34</sup>
- Sixteen of 27 market participants said the market likely would accept increasing the minimum annual income requirement, and 17 said the market likely would accept increasing the minimum net worth requirement.

The extent to which the market would accept increased thresholds would depend on which part of the market is considered. For example, according to four representatives from associations, the small business and investor communities would be resistant to increased thresholds because this would limit the pool of investors. However, according to NASAA, and an a consumer advocacy group they would support increased thresholds because it would bolster investor protection. One market participant noted that increasing the thresholds could be a problem for some existing investors if they no longer qualified under the new thresholds, and consideration would have to be given to their existing investments.

In our other interviews, market participants said that the current thresholds provide certainty and said while it is feasible to adjust them because they have not been adjusted, it would increase costs and

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<sup>34</sup>We asked market participants to rate the effects on feasibility and market acceptance on a scale of 1 to 5, with 1 being not feasible (or not likely to be accepted by the market) and 5 being feasible (or extremely likely to be accepted by the market). Ratings of 3 or higher were grouped as “feasible” or “accepted by market.”

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therefore not be well received by all market participants. For example, one industry expert and two representatives from investor associations said that the current criteria have the advantage of providing certainty for the industry, which encourages investments in start-up companies. However, the industry expert also thought the standard was overinclusive because of the increased number of people who can now meet the thresholds compared with the numbers eligible when the thresholds were first put into effect. Two representatives from industry associations also said that adjusting the thresholds upward would increase costs by changing internal systems and procedures for assessing investors' status, making the adjusted thresholds less accepted.

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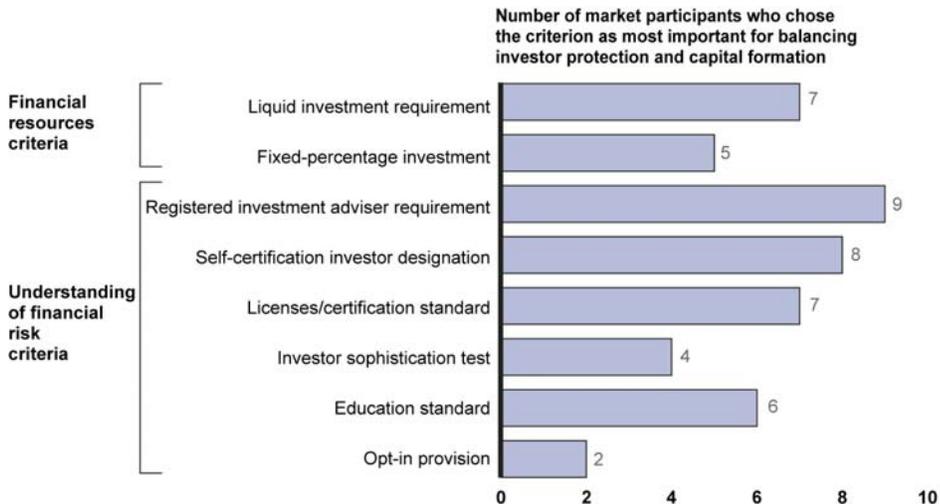
## Market Participants Identified Alternative Criteria SEC Could Use in the Investor Standard

In addition to asking about the existing criteria, we asked market participants about eight alternative criteria related to investors' financial resources and their understanding of financial risk.<sup>35</sup> We identified these alternative criteria from previous SEC proposed changes to the accredited investor standard, relevant academic literature, and criteria used by foreign regulators. While citing net worth as the most important, market participants indicated that using criteria for financial resources (25 of 27) and understanding of financial risk (22 of 27) could both be important to determine accredited investor status. Among the financial resources criteria, market participants thought a liquid investments requirement (that is, a minimum dollar amount of investments in assets that can be easily sold, are marketable, and the value of which can be verified by a financial institution) was the most important for balancing investor protection and capital formation. Among the understanding of financial risk criteria, market participants selected the use of a registered investment adviser as most important (see fig. 5).

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<sup>35</sup>We conducted structured interviews with a judgmental sample of 27 market participants recruited by their associations' leadership and their peers. The results from the structured interviews are not generalizable to the population of market participants and only represent the opinions of these 27 individuals. See appendix I for additional information on our scope and methodology and appendix III for structured interview results, in particular market participants' views of the alternative criteria that we asked about in tables 24-59.

**Figure 5: Market Participants' Views on Which Alternative Criterion Was Important for Balancing Investor Protection and Capital Formation, as of February 2013-March 2013**



Source: GAO analysis of structured interviews.

Notes: We asked which of the criteria in the two categories (financial resources or understanding of financial risk) were most important. For the financial resources criteria, respondents could have selected income and net worth, but those results are not presented in this figure. Some respondents said more than one criterion was important. As a result, for each criterion, we counted all instances in which the respondent said that a criterion was important. Therefore, totals may not add to 27.

Market participants offered varying views on alternative criteria, citing advantages and disadvantages of either replacing criteria related to an investor's financial resources or adding criteria related to an investor's understanding of financial risk.

- Liquid investments requirement.** Many market participants told us that the liquid investment criteria could either replace the current criteria or be added to it. A liquid investment requirement would require an investor to have a minimum dollar amount of investments in liquid assets, such as assets that can be easily sold, are marketable, and the value of which can be verified by a financial institution.<sup>36</sup> As shown in figure 6, 13 of 27 market participants said

<sup>36</sup>This criterion was based on an SEC proposal for an investment-owned standard and incorporated views from interviewees who said that such a standard should include liquid assets. In our questionnaire, we asked market participants their views about a criterion labeled "investments in securities" rather than liquid investments requirement. The labeling was changed in order to provide clarification in this report.

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that replacing the existing criteria with a new requirement related to an investor's liquid investments would strengthen investor protection; however, 16 said it would limit capital formation.<sup>37</sup> Many market participants thought that the liquid investments requirement should be considered as an addition to the existing accredited investor criteria.<sup>38</sup> Three market participants said it was indicative of cumulative investment experience or an investors' understanding of financial risk. Three market participants additionally commented that it was important for investors to have liquid assets because securities that are liquid could be easily liquidated to cover setbacks in investments.

Most market participants (17 of 27) said it would be feasible to replace the existing accredited investor standard with a liquid investment requirement. However, they were divided about whether it was likely to be accepted by the market (13 likely to accept, 13 unlikely to accept). Another association commented that a liquid investments requirement would be straightforward to implement. However, a few others said that investment portfolios might be difficult to verify and that asking financial institutions to verify investments would make this criterion less feasible. Two market participants as well as a representative from an industry association said that clearly defining liquid investments was important and that the definition would affect whether the criterion would be feasible.

- **Fixed-percentage investment.** Only one-third of market participants told us that the fixed-percentage criterion would strengthen investor protection (9 of 27). Few market participants told us that fixed-percentage should be considered as an addition to the current criteria (5 of 27). A fixed-percentage investment would require an investor to limit their investments in a single, nonpublic securities offering to a certain percentage of their individual net worth or income. Many market participants said replacing the current standard with fixed-percentage investments would have no effect on investor protection

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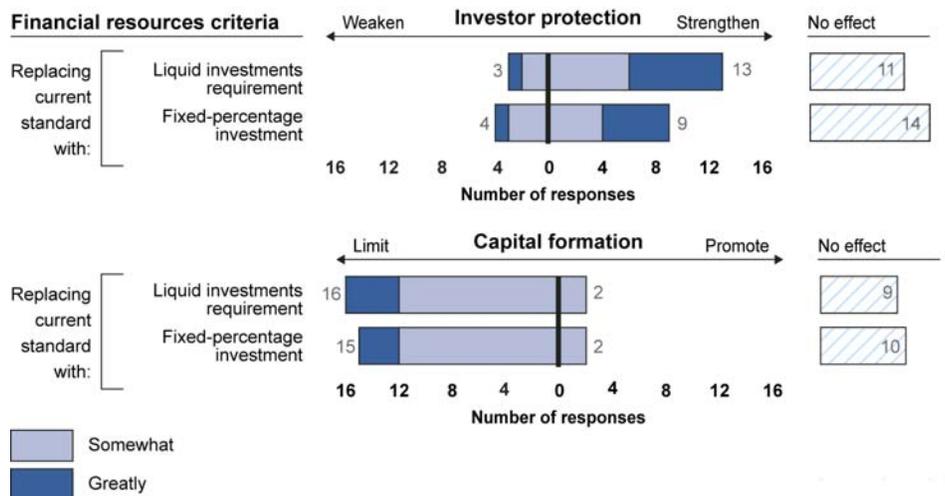
<sup>37</sup>Eleven of 27 said liquid investments would have no effect on investor protection and 3 said it would weaken it. Nine of 27 said liquid investments would have no effect on capital formation and 2 said it would promote it.

<sup>38</sup>Twenty-six of 27 market participants provided additional comments on whether a liquid investments requirement or fixed-percentage requirement should be added. Of those, 12 preferred a liquid investments requirement as an addition, 4 said either, and 1 preferred fixed-percentage investment. Seven market participants said neither should be added and 2 comments were not relevant to the topic.

(14 of 27) and that it would limit capital formation (15 of 27).<sup>39</sup> Five of 27 market participants thought that the fixed-percentage requirement should be considered as an addition to the current standard. Two market participants noted that this criterion would help to promote diversification in an investor's portfolio and could promote investor protection. For example, one representative from an industry association told us that an individual's investment portfolio would better approximate financial resources than net worth or income and another representative from an industry association said it would help to minimize risk posed to investors.

However, in general, market participants thought that replacing the existing criteria would not be feasible (18 of 27) and not likely to be accepted by the market (19 of 27). Two market participants commented that it would be difficult to implement and it might be burdensome to update and monitor the percentage figure. Furthermore, one market participant said that if an investor is only able to invest a small amount due to the fixed-percentage limit entrepreneurs might not find that small amount helpful.

**Figure 6: Market Participants' Opinions on Replacing the Current Standard with Alternative Criteria for Financial Resources, as of February-March 2013**



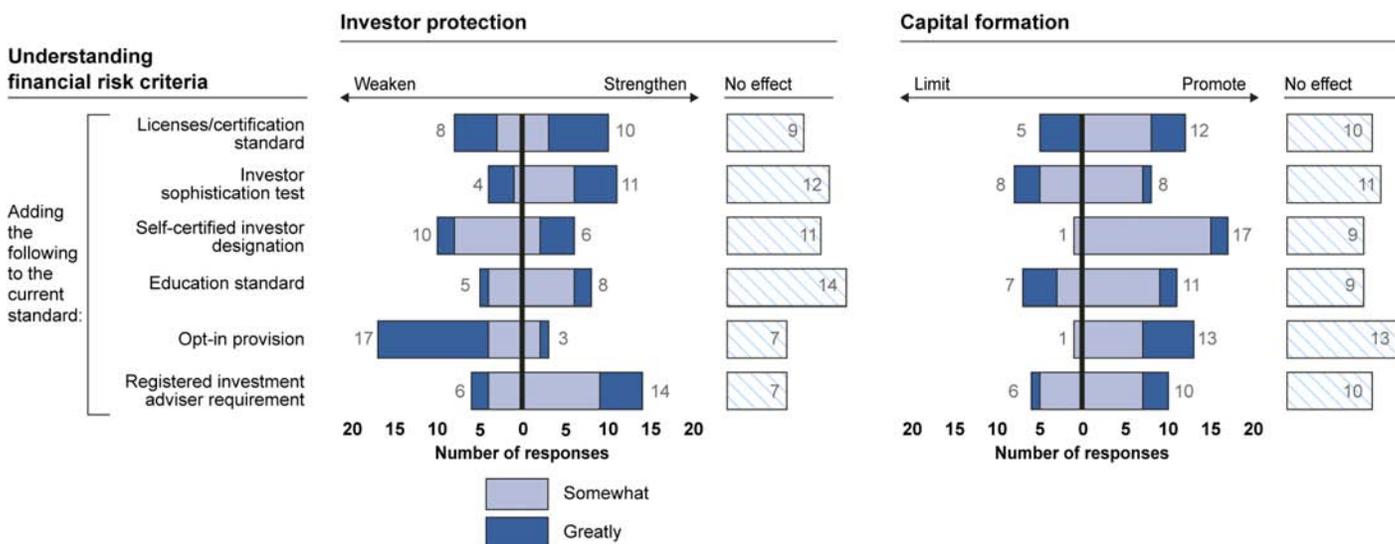
Source: GAO analysis of structured interviews.

<sup>39</sup>Nine of 27 said fixed-percentage would strengthen investor protection and 4 said it would weaken it. Ten of 27 said fixed-percentage would have no effect on capital formation and 2 said it would promote it.

Notes: We asked market participants if replacing the current standard with a liquid investments or fixed-percentage investment criterion would strengthen, weaken, or have no effect on investor protection. We then asked those who responded with strengthen or weaken if the new standard would greatly or somewhat strengthen or weaken. We also asked market participants if replacing the current standard with a liquid investments or fixed-percentage investment requirement would limit, promote, or have no effect on capital formation. We then asked those who responded with promote or limit if the new standard would greatly or somewhat promote or limit.

Market participants also offered a range of views on alternative criteria related to an investor’s understanding of financial risk. Figure 7 summarizes participants’ views on these alternatives.

**Figure 7: Market Participants’ Opinions on the Impact of Adding Criteria for Understanding Financial Risk, as of February-March 2013**



Source: GAO analysis of structured interviews.

Notes: We asked market participants if adding criteria for understanding financial risk to the current standard would strengthen, weaken, or have no effect on investor protection or capital formation. We then asked those who responded with strengthen or weaken if the effect would greatly or somewhat strengthen or weaken investor protection. We asked market participants if adding any of the criteria for understanding financial risk to the current standard would limit, promote, or have no effect on capital formation. We then asked those who responded with limit or promote if the new criterion would greatly or somewhat limit or promote capital formation. One market participant did not know the effect of adding the registered investment adviser criterion on capital formation.

- Registered investment adviser requirement.** Of the six alternative criteria related to an investor’s understanding of financial risk, participants most often said that the registered investment adviser criterion should be added to the existing criteria. That is, the criterion would require an investor who wishes to invest in a private placement offer to use the services of a registered investment adviser to manage

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their investment accounts. A majority of market participants (14 of 27) thought that adding a registered investment adviser criterion to the current standard would strengthen investor protection but were divided about its effects on capital formation (see fig. 7).<sup>40</sup> Some market participants and an industry association we interviewed noted that advisers examined the financial needs of their clients. As a result, they determined this requirement would promote investor protection.

In addition, most market participants (21 of 27) said that having a registered investment adviser criterion would be feasible to implement and that the market would be willing to accept it. For example, two market participants told us that this criterion could be feasible to implement because advisers were already vetted (registered and subject to regulation). Another market participant said that having an adviser would be a practical and objective way to approximate understanding of financial risk. However, one market participant said that this standard represents a new cost to investors because they would have to pay for the services of a registered adviser. In addition, representatives from an investment adviser firm and an angel investor group said that investment advisers might not recommend private placements because of their asset management role and compensation structure. That is, investment advisers buy and sell assets on behalf of their clients and generally base their fees on the assets managed. Because investments in private placements would be illiquid, investment advisers would not be able to manage the asset to generate greater return. As a result, the compensation structure for investment advisers would not readily accommodate private placements.

- **Self-certification investor designation.** While market participants were divided on the impact of adding a self-certification criterion on investor protection, they generally agreed on the impact on capital formation.<sup>41</sup> Through a self-certification process the investor would self-certify based on standards, such as membership in a network of investment groups, work experience (director of a company), or investment experience. Ten market participants told us a self-

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<sup>40</sup>Six of 27 said registered investment adviser criterion would weaken investor protection and 7 said it would have no effect. Six said criterion would limit investor protection and 1 said he or she did not know.

<sup>41</sup>Seventeen of 27 said self-certification would promote capital formation. Nine of 27 said self-certification would have no effect on capital formation, and 1 said it would limit it.

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certification process would weaken investor protection; 11 said it would have no effect. However, the majority (17 of 27) said it would promote capital formation. One market participant expressed concerns that individuals could self-certify to become an investor without actually meeting the qualification criteria. Another said that self-certification based on being in an investment group or being a director would not approximate understanding of financial risk. Another market participant commented that having a self-certification option would emphasize to potential investors that they should not take investments in private placements lightly.

Market participants had favorable views about the feasibility and likely market acceptance related to a self-certification criterion. A majority of market participants said that self-certification was feasible (19 of 27) and that the market would be willing to accept it (23 of 27). One market participants said that self-certification was similar to the current process in which investors self-certify that they meet either income or net worth thresholds. Moreover, representatives from an investment company association said that investment and work experience would demonstrate an individual's ability to analyze investments. However, a representative from NASAA cautioned that the standards for qualifying work experience would have to be specific.

- **License and certification standard.** Market participants had conflicting views about the effect of adding a new licenses and certification requirement to the existing criteria. Under such a criterion, an investor would have to demonstrate knowledge of financial risks related to private placement investments to receive a license from regulators or authorized third parties. About the same number of market participants said that adding such a requirement would strengthen, weaken, or have no effect on investor protection (10, 8, and 9, respectively). Furthermore, 12 of 27 participants said it would promote capital formation and 10 of 27 said that it would have no effect. Five participants said the requirement would limit capital formation. A market participant said that having a license and certification requirement would encourage unscrupulous companies to develop and issue certification without appropriately making assessments. Another market participant told us that having a license might not mean that these investors could absorb the loss.

Many market participants (15 of 27) did not think it would be feasible to add a license and certification requirement. Three market participants and two representatives from associations raised a number of issues including that some investors might be unwilling to

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take the steps to be licensed. Nevertheless, 16 of 27 market participants thought the market would accept it.

- **Investor sophistication test.** Many market participants told us that adding the sophistication test criterion to the existing criteria would not likely be accepted by the market. With this criterion, an investor would complete SEC-approved investor education classes and pass a test that would qualify them as accredited. About the same number of market participants said that adding an investor sophistication test would either strengthen or have no effect on investor protection. Furthermore, 11 of 27 participants said that there would be no effect on capital formation; the remaining were split on whether the test would promote or limit it.

While many participants (16 of 27) thought that the market would accept the addition of a test, market participants were split on whether a test would be feasible. Representatives from two industry associations suggested that investors could take the investments segment of the examination for stockbrokers. However, two market participants raised questions about whether investors would be willing to take the test or spend time to prepare for it and take a test to become a certified sophisticated investor. Furthermore, representatives from another association said the test could quickly become overly complex given the variety of investments available and the frequency of changes in investment products. Also, representatives from associations questioned who would administer the test and where the resources to administer the test would come from.

- **Education standard.** Under this criterion, an investor would qualify as accredited based on an advanced degree in business or finance, or a chartered financial analyst credential or similar designation. While 14 of 27 market participants told us that an education criterion would have no effect on investor protection, 11 of the participants said education would promote capital formation.<sup>42</sup> For example, one market participant said that the education criterion would allow younger people who might not have financial resources but understood financial risks to invest in private placement offerings. However, two market participants said that having an advanced

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<sup>42</sup>Eight of 27 said education would strengthen investor protection and 5 said it would weaken it. Nine of 27 said the criterion would have no effect on capital formation and 7 said the criterion would limit it.

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degree, such as in business, would not necessarily give an investor the necessary knowledge to invest wisely. A majority of market participants said that an education criterion would be feasible (23 of 27) and that the market would be willing to accept it (18 of 27). Representatives from one industry association we interviewed said verifying education would be a simple process. However, one market participant said that market acceptance would depend on the documentation that would be required of the investor.

- **Opt-in provision.** Market participants' views were divided about the inclusion of an opt-in provision. With an opt-in provision, the investor would sign a statement that waives significant rights to file a complaint to seek compensation unless there is fraud on the part of the issuer. A majority (17 of 27) of market participants said that the provision would decrease investor protection.<sup>43</sup> One market participant commented that the provision would decrease investor protection because it would take away the burden of proof from an issuer in relation to fraud. An equal number of participants said that it would promote or have no effect on capital formation. Market participants had more favorable views about the feasibility and likely market acceptance of a new opt-in criterion. A majority of market participants said that it would be feasible (17 of 27) and that the market would be willing to accept it (21 of 27). For example, one market participant said that an opt-in form would be easy to implement. However, two market participants noted that state securities regulators would object strongly to the addition of this criterion because it decreased protection for investors.

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## Conclusions

The intended purposes of the accredited investor standard are to protect investors and streamline capital formation for small businesses. However, beyond excluding an investor's primary residence in the calculation of net worth in 2010, the standards for qualifying as an individual accredited investor have remained unchanged since the 1980s. As a result, some market participants and policymakers have raised concerns about diminished investor protection as the numbers of individuals able to qualify as accredited has increased over the years. Of the existing criteria for qualifying as an accredited investor, most market participants with whom we spoke said that net worth was the most important criterion for balancing investor protection and capital formation. However, these

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<sup>43</sup>Seven of 27 said the provision would have no effect on investor protection and 3 said it would strengthen it.

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participants also identified alternative criteria that could also achieve these goals. Specifically, market participants we spoke with most often supported adding an investment requirement or use of an investment adviser as an alternative criterion that would balance investor protection and capital formation, be relatively feasible to implement, and have some level of acceptance by the market. SEC must review the definition of accredited investor every 4 years beginning in 2014. Our report on market participants' views on the existing and alternative qualification criteria for accredited investor status will be published in July 2013. By examining the potential effects of the existing and alternative criteria when it conducts its review in 2014, SEC could help ensure that it is using the most appropriate ones for qualifying investors as accredited.

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## Recommendation for Executive Action

To further advance the goals of balancing investor protection and capital formation in its accredited investor standard, SEC should consider alternative criteria, including those in this report, to help determine an individual's ability to bear and understand the risks associated with investing in private placements. For example, market participants that we spoke with identified adding a liquid investment requirement or use of an investment adviser as alternative criteria that would balance investor protection and capital formation, be relatively feasible to implement, and have some level of acceptance by the market.

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## Agency Comments

We provided SEC a draft copy of this report for their review and comment. SEC provided written comments that are reprinted in appendix IV. SEC also provided technical comments that were incorporated as appropriate.

In its written comments, SEC agreed with our recommendation. Specifically, SEC noted that the Dodd-Frank Act requires the agency to review the definition of accredited investors four years after the law's enactment. SEC said that it would consider alternative criteria (particularly, adding liquid investments and the use of a registered adviser) when it completes its mandated review.

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We are sending copies of this report to the Chairman of the Securities and Exchange Commission, the appropriate congressional committees, and other interested parties. In addition, the report will be available at no charge on GAO's website at <http://www.gao.gov>.

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If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or [clowersa@gao.gov](mailto:clowersa@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



A. Nicole Clowers  
Director, Financial Markets  
and Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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This report examines market participants' views on (1) the existing criteria for qualifying for accredited investor status, and (2) alternative financial and other qualification criteria.

For both objectives, we reviewed the Securities and Exchange Commission's (SEC) current definition and legislative history of the standard. We reviewed SEC's proposed changes to the accredited investor standard since 2006, market participants' comment letters to SEC regarding these proposals, and academic literature related to accredited investors and private placements. We interviewed and asked officials from the SEC, Financial Industry Regulatory Authority (FINRA), and North American Securities Administrators Association (NASAA) for their views about the current and proposed accredited investor standards. We asked SEC, FINRA, NASAA, the Department of Treasury, Commodity Futures Trade Commission, and Consumer Financial Protection Bureau about any financial literacy efforts directed at individuals who qualify as accredited investors and they told us that they were not aware of any relevant financial literacy efforts that we could consider. We interviewed officials from the Ontario (Canada) Securities Commission and United Kingdom Financial Services Authority to obtain information about their investor standards, especially those similar to the U.S. accredited investor standard. We conducted interviews with academics; lawyers knowledgeable about accredited investor issues; other securities market and investment experts; trade associations representing investors, capital formation groups, small businesses, and private equity groups. These associations included the Securities Industry and Financial Markets Association, Angel Capital Association (ACA), National Venture Capital Association (NVCA), American Association of Individual Investors (AAII), Investment Adviser Association (IAA), National Small Business Association, SecondMarket, and the Investment Company Institute.

To examine market participants' views on the existing criteria for accredited investor status, and the potential effects of changes to the standard on investor protection and capital formation, we conducted structured interviews by telephone with a judgmental sample of 27 market participants whom we categorized in four groups intended to represent different segments of the accredited investor population: (1) attorneys who have experience in private placement transactions, (2) accredited investors who invest in private placement securities, (3) retail investors who meet the current accredited investor criteria but do not actively invest in private placement securities, and (4) investment advisers and broker-dealers who work with accredited investors. We asked the participants of the structured interviews (market participants) about the feasibility,

likelihood of market acceptance, and impact on investor protection and capital formation of adjusting the existing criteria.<sup>1</sup> We worked with associations to identify market participants to interview. We identified seven associations that represent the types of individuals in the four groups described above. These associations are the American Bar Association, the Securities Industry and Financial Markets Association, the Financial Services Institute, ACA, AAIL, IAA, and NVCA. We selected these groups from a broader list of organizations we previously identified as knowledgeable about accredited investors or that were recommended by others. These organizations then recruited members to participate in the interviews. We also asked participants for referrals to other individuals who might be interested in participating.

Our sample of 27 market participants consisted of 11 attorneys, 5 investment advisers, 5 angel investors, and 6 retail investors who qualify as accredited investors but do not actively invest in unregistered securities. We asked them demographic questions to learn more about their backgrounds and help put their responses in context.

- We interviewed 11 attorneys, of whom 1 had more than 4 years of experience with Regulation D transactions, 1 had more than 11 years of experience, and 9 had more than 20 years. They represented accredited investors, issuers, and placement agents and practiced in different cities throughout the United States, although 5 were located in New York City or Washington, D.C.
- We interviewed 5 broker-dealers or investment advisers: 3 said they recommended Regulation D investments to clients at least once a week; 1 said once a month; and 1 said several times a year. The size of their firms ranged from less than 50 employees to 5,000 employees or more. We did not ask the advisers about their geographic location.
- We interviewed 5 angel investors, 1 of whom had 4 more than 10 years of experience investing in private placements, and 4 who had

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<sup>1</sup>We defined feasibility as the simplicity and ease with which the proposed change to the accredited investor qualification could be implemented in the securities market. We defined market acceptance as the willingness of the current marketplace and any new market players established by the proposed change to accept the new accredited investor qualification. We explained effects on investor protection as how any proposed change to the accredited investor qualification would or would not maintain market participants' legal protections for similar financial products and services (including sales practice standards and suitability requirements). For capital formation, we emphasized how any change would or would not facilitate capital formation for businesses.

more than 11 years of experience. They invested in industries including information technology, biotechnology, health care, energy, medical devices and equipment, and energy. The companies in which the group members invested were primarily located in the Midwest, but two individuals invested in start-up companies throughout the United States.

- We interviewed 6 retail investors over the age of 55, all of whom had at least a bachelor's degree and 1 of whom occasionally used the services of an investment adviser. They resided in different regions of the United States.

We conducted the structured interviews from February through March 2013. One team member asked the questions while a second recorded the responses in a web-based questionnaire. We took steps to minimize errors, such as difficulties interpreting a particular question, by pretesting the interview questions with one member from each of the groups in January 2013. We conducted pretests to make sure that the questions were clear and unbiased and that they did not place an undue burden on respondents. An independent survey specialist within GAO also reviewed a draft of the questions prior to their administration. We made appropriate revisions to the content and format of the questionnaire after the pretests and independent review. The results from the structured interviews are not generalizable to the population of market participants and only represent the opinions of these 27 individuals. However, as described above we took steps to obtain opinions from a diverse group of market participants.

Because the population of accredited investors is unknown, we performed an additional analysis to suggest how changing the thresholds for net worth and income would affect the pool of eligible investors. We used data from the Survey of Consumer Finances (SCF), which the Board of Governors of the Federal Reserve System (Federal Reserve) issues every 3 years, to examine how changing the thresholds would affect the pool of eligible households represented by survey respondents. For the purposes of this analysis, a household refers to the primary economic unit within a household (to which the SCF refers as a family). We used net worth and income as defined in a Federal Reserve publication about the SCF.<sup>2</sup> For net worth, we excluded home equity. We did not attempt to

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<sup>2</sup>See Jesse Bricker, et al., "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 98, no. 2 (Washington, D.C.: June 2012).

determine the appropriate threshold based on a household’s marital status. For the estimates in table 3, we followed SCF guidance and estimated the standard errors (which appear in parentheses). We found the data to be sufficiently reliable to evaluate household income and net worth levels.

**Table 3: Estimates and Standard Errors for Number of Households by Various Income and Net worth Thresholds, 2010**

Income thresholds	No. of households	Net worth thresholds	No. of households
\$100,000	21,594,413 (568,939)	\$250,000	23,236,369 (676,120)
\$200,000	6,082,187 (253,009)	\$1,000,000	8,461,537 (341,419)
\$300,000	3,275,211 (188,025)	\$1,750,000	4,557,745 (305,970)
\$400,000	2,412,365 (165,145)	\$2,500,000	3,361,619 (252,454))
\$500,000	1,686,801 (123,750)	\$3,250,000	2,668,236 (168,482)

Source: GAO analysis of Federal Reserve data.  
 Note: Standard errors in parentheses.

To examine market participants’ views on alternative financial and other qualification criteria, we identified accredited investor criteria that market participants and others proposed, and identified relevant criteria used by the Ontario (Canada) Securities Commission and the United Kingdom Financial Services Authority to qualify similar types of investors. From the list of proposed and foreign regulator criteria, we identified a list of criteria that was consistent with the intended purpose of the accredited investor standard and that could be used to qualify individual investors as accredited. We grouped these criteria into two categories: investors’ access to financial resources and their understanding of financial risk.

(1) Investor’s financial resources

- **Liquid investments requirement.** Investors would have to have a minimum dollar amount of investment in liquid assets (that is, assets that can be easily sold, are marketable, and the value of which can be verified by a financial institution).

- **Fixed-percentage investment.** Investors would be limited in their investments in single, nonpublic securities offerings to a certain percentage of their individual net worth or income.

(2) Investor's understanding of financial risk

- **Licenses/certification.** Investors would have to demonstrate knowledge of financial risks related to private placement investments to receive licenses from regulators or authorized third parties.
- **Investor sophistication test.** Investors would complete SEC-approved investor education classes and pass a test that would qualify them as accredited.
- **Self-certifying as a sophisticated investor.** Investors would self-certify based on standards such as membership in a network of investment groups, work experience, or investment experience.
- **Education.** Investors would qualify as accredited based on an advanced degree in business or finance, a chartered financial analyst credential, or similar designation.
- **Opt-in provision.** Investors would sign a statement that waives significant rights to file a complaint or seek compensation unless there is fraud on the part of the issuer.
- **Registered investment adviser requirement.** Investors who wished to invest in private placement offerings would have to use the services of registered investment advisers to manage their investment accounts.

We asked the 27 market participants if the current standard (income and net worth) should be adjusted and to identify the most important criteria for balancing capital formation and investor protection from the two respective categories. We asked the market participants three different lines of questions: (1) the effect of increasing or decreasing the minimum income or net worth thresholds; (2) the effect of replacing the current standard with an alternative criterion for financial resources; (3) the effect of adding a criterion for understanding financial risk to the current standard. By replace, we meant that potential investors must qualify under the alternative criterion. By add, we meant if potential investors did not qualify under the current standard, they could qualify under an alternative. For each criterion, we asked about the effects on feasibility, likelihood of market acceptance, and impact on investor protection and capital formation. We did not ask about the effects of adding alternative financial resources criteria to the current standard or replacing the current standard with criteria for understanding financial risk. However, we asked market participants if the current standard should be added with a

criterion for financial resources and if any criterion for understanding financial risk should be replaced to the current standard. Appendix III includes the questions that we asked market participants and our results.

We compared response patterns between the four types of market participants that we interviewed and found that generally, there were little differences in those patterns. A response pattern is the variability in response options chosen. For example, all 11 lawyers responded that the education standard was feasible, whereas other groups responded that it was feasible (12) or somewhat or not feasible (4). However, we cannot conclude that the differences indicate a statistical difference in opinion because of the small and varying sample sizes of each group and the fact that they are not statistically representative samples.

We conducted this performance audit from June 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Summary of Rules for Exemption from Registration under Regulation D

The Securities Act of 1933 generally requires securities issuers to register securities offerings with SEC. However, the act exempts certain offerings from registration, which SEC has implemented by regulation when it determines that the registration procedure is not required for investor protection. Regulation D, adopted by SEC in 1982, describes terms and conditions that qualify a securities offering for an exemption from registration. Regulation D contains multiple rules, which include definitions of terms, general conditions applicable to the offerings, requirements for exemptions, and deadlines for notices of claims of exemptions. Table 4 summarizes Rules 504, 505, and 506, which establish registration exemptions.

**Table 4: Summary of Requirements for Exemptions under Rules 504-506 of SEC Regulation D, as of June 14, 2013**

Requirements for exemption	Rule 504	Rule 505	Rule 506
Number and type of investors who may invest	No set investor limit	An unlimited number of accredited investors and up to 35 nonaccredited investors	An unlimited number of accredited investors and up to 35 nonaccredited, sophisticated investors
Maximum dollar size of securities offering	Up to \$1 million in any 12-month period	Up to \$5 million in any 12-month period	No set dollar limit
Restricted securities resales	Yes, unless certain conditions are met	Yes	Yes
Disclosure documents required to be delivered to investors	Under state law requirements pursuant to certain conditions	Yes, to non-accredited investors	Yes, to non-accredited investors
Restrictions on general solicitation and advertising for investors	Yes, unless certain conditions are met	Yes	Yes
Subject to federal and state antifraud provisions	Yes	Yes	Yes
SEC Form D filing required	Yes	Yes	Yes
State registration required	Yes, unless there is a state exemption	Yes, but most states have state exemptions, such as the Uniform Limited Offering Exemption	No, preempted from state registration by National Securities Markets Improvement Act of 1996
Type of issuers that cannot use exemption	Blank check companies, investment companies, or SEC reporting companies	Investment companies	None

Source: GAO analysis of Regulation D rules.

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# Appendix III: Summary of Results from Our Structured Interviews

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We conducted structured interviews to determine the potential impact on investor protection and capital formation of replacing or adding alternative criteria to the existing criteria for determining accredited investor status. We also asked market participants' opinions about the potential impact on investor protection and capital formation of marketing and advertising securities offerings under Regulation D, Rule 506. We interviewed 27 individuals representing different segments of the accredited investor population: 11 attorneys who represent issuers of private placements, 5 investment advisers, 5 individuals who are active investors in private placements, and 6 individuals who meet the current criteria for accredited investor status but are not active investors. The interviews were conducted from February through March 2013. For more information about our methodology for designing and conducting these interviews, see appendix I.

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**Table 5: Do You Believe the Current Qualification Criteria Should be Adjusted or Should Not Be Adjusted?**

Response	Count
Should be adjusted	13
Should not be adjusted	11
Don't know	3

Source: GAO analysis of structured interviews.

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**Table 6: On a Scale of 1 to 5, Where 1 Is Not Important and 5 Is Extremely Important, How Important Are Financial Resources in Determining Accredited Investor Status?**

Response	Count
1 (not important)	0
2	2
3	3
4	9
5 (extremely important)	13

Source: GAO analysis of structured interviews.

**Table 7: On a Scale of 1 to 5, Where 1 Is Not Important and 5 Is Extremely Important, How Important Is Understanding Financial Risk in Determining Accredited Investor Status?**

Response	Count
1 (not important)	2
2	3
3	3
4	9
5 (extremely important)	10

Source: GAO analysis of structured interviews.

**Table 8: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Increasing the Minimum Annual Income Requirement?**

Response	Count
1 (not feasible)	0
2	2
3	6
4	2
5 (extremely feasible)	17

Source: GAO analysis of structured interviews.

**Table 9: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Increasing the Minimum Annual Income Requirement?**

Response	Count
1 (not likely)	3
2	8
3	8
4	4
5 (extremely likely)	4

Source: GAO analysis of structured interviews.

**Table 10: Would Increasing the Minimum Annual Income Requirement Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	4
Somewhat strengthen	9
No effect	10
Somewhat weaken	1
Greatly weaken	2
Refuse to answer	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 11: Would Increasing the Minimum Annual Income Requirement Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	0
Somewhat promote	1
No effect	8
Somewhat limit	11
Greatly limit	7

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 12: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Decreasing the Minimum Annual Income Requirement?**

Response	Count
1 (not feasible)	3
2	2
3	2
4	3
5 (extremely feasible)	17

Source: GAO analysis of structured interviews.

**Table 13: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Decreasing the Minimum Annual Income Requirement?**

Response	Count
1 (not likely)	2
2	1
3	1
4	6
5 (extremely likely)	17

Source: GAO analysis of structured interviews.

**Table 14: Would Decreasing the Minimum Annual Income Requirement Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	0
Somewhat strengthen	3
No effect	7
Somewhat weaken	11
Greatly weaken	6

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 15: Would Decreasing the Minimum Annual Income Requirement Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	4
Somewhat promote	17
No effect	5
Somewhat limit	0
Greatly limit	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 16: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Increasing the Minimum Net Worth Requirement?**

Response	Count
1 (not feasible)	2
2	1
3	4
4	7
5 (extremely feasible)	13

Source: GAO analysis of structured interviews.

**Table 17: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Increasing the Minimum Net Worth Requirement?**

Response	Count
1 (not likely)	4
2	6
3	11
4	3
5 (extremely likely)	3

Source: GAO analysis of structured interviews.

**Table 18: Would Increasing the Minimum Net Worth Requirement Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	4
Somewhat strengthen	9
No effect	12
Somewhat weaken	1
Greatly weaken	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 19: Would Increasing the Minimum Net Worth Requirement Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	0
Somewhat promote	2
No effect	10
Somewhat limit	11
Greatly limit	4

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 20: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Decreasing the Minimum Net Worth Requirement?**

Response	Count
1 (not feasible)	2
2	2
3	4
4	5
5 (extremely feasible)	14

Source: GAO analysis of structured interviews.

**Table 21: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Decreasing the Minimum Net Worth Requirement?**

Response	Count
1 (not likely)	2
2	2
3	0
4	7
5 (extremely likely)	16

Source: GAO analysis of structured interviews.

**Table 22: Would Decreasing the Minimum Net Worth Requirement Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	0
Somewhat strengthen	1
No effect	6
Greatly weaken	6
Somewhat weaken	14

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 23: Would Decreasing the Minimum Net Worth Requirement Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	4
Somewhat promote	14
No effect	6
Somewhat limit	3
Greatly limit	0

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 24: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Replacing the Current Standard with a Liquid Investment Requirement?**

Response	Count
1 (not feasible)	6
2	4
3	7
4	5
5 (extremely feasible)	5

Source: GAO analysis of structured interviews.

**Table 25: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Replacing the Current Standard with a Liquid Investment Requirement?**

Response	Count
1 (not likely)	6
2	7
3	9
4	3
5 (extremely likely)	1
Don't Know	1

Source: GAO analysis of structured interviews.

**Table 26: Would Replacing the Current Standard with a Liquid Investment Requirement Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	7
Somewhat strengthen	6
No effect	11
Greatly weaken	1
Somewhat weaken	2

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 27: Would Replacing the Current Standard with a Liquid Investment Requirement Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	0
Somewhat promote	2
No effect	9
Somewhat limit	12
Greatly limit	4

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 28: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Is Replacing the Current Standard with a Fixed-Percentage Investment?**

Response	Count
1 (not feasible)	6
2	12
3	4
4	2
5 (extremely feasible)	3

Source: GAO analysis of structured interviews.

**Table 29: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Replacing the Current Standard with a Fixed-Percentage Investment?**

Response	Count
1 (not likely)	6
2	13
3	8
4	0
5 (extremely likely)	0

Source: GAO analysis of structured interviews.

**Table 30: Would Replacing the Current Standard with a Fixed-Percentage Investment Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	5
Somewhat strengthen	4
No effect	14
Somewhat weaken	3
Greatly weaken	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 31: Would Replacing the Current Standard with a Fixed-Percentage Investment Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	0
Somewhat promote	2
No effect	10
Somewhat limit	12
Greatly limit	3

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 32: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add a Licenses or Certification Standard to the Current Standard?**

Response	Count
1 (not feasible)	8
2	7
3	4
4	5
5 (extremely feasible)	3

Source: GAO analysis of structured interviews.

**Table 33: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding Licenses or Certification to the Current Standard?**

Response	Count
1 (not likely)	6
2	5
3	2
4	9
5 (extremely likely)	5

Source: GAO analysis of structured interviews.

**Table 34: Would Adding a Licenses or Certification Standard to the Current Standard Strengthen, Weaken, or Have no Effect on Investor Protection?**

Response	Count
Greatly strengthen	7
Somewhat strengthen	3
No effect	9
Somewhat weaken	3
Greatly weaken	5

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 35: Would Adding a Licenses or Certification Standard to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	4
Somewhat promote	8
No effect	10
Somewhat limit	0
Greatly limit	5

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 36: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add an Investor Sophistication Test to the Current Standard?**

Response	Count
1 (not feasible)	8
2	6
3	6
4	3
5 (extremely feasible)	4

Source: GAO analysis of structured interviews.

**Table 37: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding an Investor Sophistication Test to the Current Standard?**

Response	Count
1 (not likely)	6
2	5
3	6
4	4
5 (extremely likely)	6

Source: GAO analysis of structured interviews.

**Table 38: Would Adding an Investor Sophistication Test to the Current Standard Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	5
Somewhat strengthen	6
No effect	12
Somewhat weaken	1
Greatly weaken	3

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 39: Would Adding an Investor Sophistication Test to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	1
Somewhat promote	7
No effect	11
Somewhat limit	5
Greatly limit	3

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 40: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add a Self-Certified Sophisticated Investor Designation to the Current Standard?**

Response	Count
1 (not feasible)	5
2	3
3	5
4	3
5 (extremely feasible)	11

Source: GAO analysis of structured interviews.

**Table 41: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding a Self-Certified Sophisticated Investor Designation to the Current Standard?**

Response	Count
1 (not likely)	4
2	0
3	4
4	10
5 (extremely likely)	9

Source: GAO analysis of structured interviews.

**Table 42: Would Adding a Self-Certified Sophisticated Investor Designation to the Current Standard Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	4
Somewhat strengthen	2
No effect	11
Somewhat weaken	8
Greatly weaken	2

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 43: Would Adding a Self-Certified Sophisticated Investor Designation to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	2
Somewhat promote	15
No effect	9
Somewhat limit	1
Greatly limit	0

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 44: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add an Education Standard to the Current Standard?**

Response	Count
1 (not feasible)	3
2	1
3	4
4	10
5 (extremely feasible)	9

Source: GAO analysis of structured interviews.

**Table 45: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding an Education Standard to the Current Standard?**

Response	Count
1 (not likely)	3
2	6
3	6
4	6
5 (extremely likely)	6

Source: GAO analysis of structured interviews.

**Table 46: Would Adding an Education Standard to the Current Standard Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	2
Somewhat strengthen	6
No effect	14
Somewhat weaken	4
Greatly weaken	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 47: Would Adding an Education Standard to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	2
Somewhat promote	9
No effect	9
Somewhat limit	3
Greatly limit	4

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 48: On a Scale of 1 to 5, Where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add an Opt-in Provision to the Current Standard?**

Response	Count
1 (not feasible)	7
2	3
3	4
4	5
5 (extremely feasible)	8

Source: GAO analysis of structured interviews.

**Table 49: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding an Opt-in Provision to the Current Standard?**

Response	Count
1 (not likely)	4
2	2
3	6
4	3
5 (extremely likely)	12

Source: GAO analysis of structured interviews.

**Table 50: Would Adding an Opt-in Provision to the Current Standard Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	1
Somewhat strengthen	2
No effect	7
Somewhat weaken	4
Greatly weaken	13

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 51: Would Adding an Opt-in Provision to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	6
Somewhat promote	7
No effect	13
Somewhat limit	1
Greatly limit	0

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 52: This Proposal Would Be a Requirement in Which an Individual’s Investments are Managed by a Registered Adviser. On a Scale of 1 to 5, where 1 Is Not Feasible and 5 Is Extremely Feasible, How Feasible Would It Be to Add This Requirement to the Current Standard As an Alternative to the Current Standard?**

Response	Count
1 (not feasible)	2
2	4
3	4
4	5
5 (extremely feasible)	12

Source: GAO analysis of structured interviews.

**Table 53: On a Scale of 1 to 5, Where 1 Is Not Likely and 5 Is Extremely Likely, How Likely Is It That the Market Would Accept Adding This Requirement to the Current Standard?**

Response	Count
1 (not likely)	5
2	1
3	3
4	7
5 (extremely likely)	11

Source: GAO analysis of structured interviews.

**Table 54: Would Adding This Requirement to the Current Standard Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	5
Somewhat strengthen	9
No effect	7
Somewhat weaken	4
Greatly weaken	2

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

**Table 55: Would Adding this Requirement to the Current Standard Promote, Limit, or Have No Effect on Capital Formation for Businesses?**

Response	Count
Greatly promote	3
Somewhat promote	7
No effect	10
Greatly limit	1
Somewhat limit	5
Don't know	1

Source: GAO analysis of structured interviews.

Note: Respondents were asked if a proposed change to financial resources criteria, or understanding financial risk criteria, would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation.

**Table 56: Which of the Financial Resource Criteria (Income, Net Worth, Investments in Securities, or Fixed-Percentage Investment) Is Most Important for Balancing Investor Protection and Capital Formation?**

Criteria	Count
Net worth	9
Income	1
Investments in securities	4
Fixed percent investment	4
Other	9

Source: GAO analysis of structured interviews.

**Table 57: Assuming the Current Standard Remains the Same, Should Liquid Investment Requirement or Fixed-Percentage Be Considered as Additions to The Current Standard?**

Response	Count
Yes	18
No	7
Don't know	2

Source: GAO analysis of structured interviews.

**Table 58: Which of the Understanding Financial Risk Criteria (Licenses/Certification, Investor Sophistication Test, Self-Certification, Education, Opt-in Provision, Investments Managed by a Registered Adviser) Best Balance Investor Protection and Capital Formation?**

Criteria	Count
Licenses/certification	3
Investor sophistication test	2
Self-certified sophisticated investor designation	4
Education	1
Opt-in provision	1
Managed by registered adviser	7
Other	9

Source: GAO analysis of structured interviews.

**Table 59: Should Any of the Understanding Financial Risk Criteria (Licenses/Certification, Investor Sophistication Test, Self-Certification, Education, Opt-in Provision, Investments Managed By a Registered Adviser) Be Considered as Replacements to the Current Standard?**

Response	Count
Yes	7
No	20

Source: GAO analysis of structured interviews.

**Table 60: SEC Currently Prohibits General Solicitation and Advertising to Investors. But under the JOBS Act, SEC Will Lift the Prohibition Once a Final Rule Is in Place. Would Lifting the Prohibition Strengthen, Weaken, or Have No Effect on Investor Protection?**

Response	Count
Greatly strengthen	0
Somewhat strengthen	0
Greatly weaken	7
Somewhat weaken	8
No effect	10
Don't know	1

Source: GAO analysis of structured interviews.

Notes: Respondents were asked if lifting the prohibition on general solicitation and advertising to investors would strengthen, weaken, or have no effect on investor protection. Those that responded that a change would strengthen or weaken investor protection were then asked if the proposed change would greatly or somewhat strengthen (or weaken) investor protection.

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**Appendix III: Summary of Results from Our Structured Interviews**

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One respondent said lifting the prohibition would weaken investor protection, but did not know if it would greatly or somewhat weaken.

**Table 61: Would Lifting the Prohibition Promote, Limit, or Have no Effect on Capital Formation?**

<b>Response</b>	<b>Count</b>
Greatly promote	10
Somewhat promote	12
Greatly limit	1
Somewhat limit	0
No effect	1
Don't know	2

Source: GAO analysis of structured interviews.

Note: Respondents were asked if lifting the prohibition on general solicitation and advertising to investors would promote, limit, or have no effect on capital formation. Those that responded that a change would promote or limit capital formation were then asked if the proposed change would greatly or somewhat promote (or limit) capital formation. One respondent said lifting the prohibition would promote capital formation, but did not know if it would greatly or somewhat promote.

# Appendix IV: Comments from the Securities and Exchange Commission



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

July 1, 2013

Ms. A. Nicole Clowers  
Director  
Financial Markets and Community Investment  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Clowers:

Thank you for the opportunity to review the draft of the report entitled "Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered." We appreciate the insight that this draft report provides about alternative criteria for qualifying as an accredited investor. The staff of the Securities and Exchange Commission is separately providing you with technical comments on the draft report.

As discussed in the draft report, Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to review the definition of the term "accredited investor" in its entirety four years after the enactment of the Dodd-Frank Act. In preparing its recommendations to the Commission, the staff will factor in the views of the GAO that the SEC should consider alternative criteria for the accredited investor standard, and in particular, adding liquid investments and use of a registered adviser as alternative criteria.

We appreciate the GAO's attention to this important issue and would like to thank you and your staff for your work.

Sincerely,

A handwritten signature in blue ink, which appears to read "Keith F. Higgins", is positioned above the typed name.

Keith F. Higgins  
Director  
Division of Corporation Finance

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# Appendix V: GAO Contact and Staff Acknowledgments

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## GAO Contact

A. Nicole Clowers, (202) 512-8678 or [clowersa@gao.gov](mailto:clowersa@gao.gov)

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## Staff Acknowledgments

In addition to the individual named above, Triana McNeil (Assistant Director), Benjamin Bolitzer, Jeremy Conley, William Chatlos, Katherine Bittinger Eikel, Elizabeth Jimenez, Jill Lacey, Angela Messenger, Marc Molino, Barbara Roesmann, Jessica Sandler, and Weifei Zheng made major contributions to this report.

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