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**The SEC Considers Updating the
Accredited Investor Definition:
A Discussion of Status,
SEC Advisory Committee
Recommendations, Comments and
Proposed Legislation**

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May 2015

Updated July 2015

www.mcguirewoods.com

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Executive Summary

The accredited investor (AI) definition is an extremely important component of the private placement market. A significant amount of capital is raised using Regulation D, and accredited investors participated in 89 percent of reported Regulation D offerings from January 2009 through December 2012. (In other words, only 11 percent of reported Regulation D offerings during this period involved non-accredited investors.)

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires that the Securities and Exchange Commission (SEC) review the AI definition for natural persons beginning in 2014 and every four years thereafter. The SEC has received a significant number of comment letters concerning the AI definition for natural persons and two SEC advisory committees have made recommendations to the SEC on this issue. Also, legislation concerning the AI definition has been introduced in the U.S. Congress.

Currently an individual is an AI if that person:

- earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year; or
- has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person's primary residence, as calculated in accordance with the rule).

See Regulation D, Rule 501(a).

A lot of people, including an extremely large number of people associated with angel investor groups, have recommended that the AI definition remain as is, in other words, that the current AI financial thresholds remain in place. The vast majority of the comment letters received by the SEC take this view.

The \$200,000 income and \$1 million net worth tests for individuals were established in 1982. The \$300,000 income test that includes spousal income was added in 1988. Effective in 2012, the value of a person's primary residence was eliminated from the net worth calculation. In other words, the basic AI qualification test for individuals has been in place since 1982. This fact has resulted in discussion as to whether the income and net worth thresholds for individual AIs should be changed.

Possible Adjustment of Financial Thresholds

Some of the discussion has focused on whether these financial thresholds should be raised. If these financial thresholds were adjusted for inflation, the income threshold would increase to just under \$500,000 (\$740,000 for a married couple), and the net worth criteria would increase from \$1 million to almost \$2.5 million. While the data is not entirely clear as to the extent of the impact, it is probable that an increase in the financial thresholds of this magnitude would have a material adverse impact on the private placement market.

Very few people are advocating that the income and net worth thresholds be adjusted for inflation since 1982.¹ Accordingly, it is very unlikely that the SEC will simply increase the AI financial thresholds to adjust for inflation since 1982.

However, a few commenters have recommended that these thresholds be adjusted for inflation on a going-forward basis, and the SEC's Advisory Committee on Small and Emerging Companies (Small Companies Committee) has recommended this change.

Allow a Percentage of Income or Net Worth to Be Used in Qualifying Private Placements

The SEC's Investor Advisory Committee (Investor Committee) has endorsed a new approach to the financial thresholds in the AI definition based on a percentage of income or net worth. This approach would be similar to the investment limitations in the SEC's proposed crowdfunding rule.

Add a New AI Category for Financial Sophistication

The Investor Committee and the Small Companies Committee (together, the Advisory Committees), as well as a large number of angel investors, have recommended that the AI definition be expanded to include a new category of AI based upon "sophistication."

By "sophistication," these commenters mean that a person could qualify as an AI without regard to the financial thresholds if that person had knowledge or experience that indicated financial literacy. The various ways that have been advanced to implement this concept are explained in more detail below.

The SEC staff has stated publicly that it is considering this concept. Because of the rather broad support for the addition of financial sophistication as a factor that results in AI status, there is a realistic chance that the SEC staff will recommend that the SEC consider this kind of change. The more difficult part will be how to structure the new AI standard in a practical sense.

Other Suggestions

Investor protection advocates and others have recommended a variety of other changes to the AI definition. These potential changes include revising the net worth calculation to exclude retirement assets.

Although the SEC has publicly stated that it is considering this potential change, neither of the Advisory Committees recommended it.

Proposed Legislation

Legislation has been introduced in the House of Representatives (H.R. 2187) which, if passed, would direct the SEC to expand the ways in which an individual would qualify as an AI (the AI Bill). The AI Bill includes a number of the concepts that have been advanced in comment letters and considered by the Advisory Committees.

The AI Bill proposed that the SEC provide AI status to individuals who pass a test administered by the Financial Industry Regulatory Authority (FINRA) based on criteria set by the SEC, and people who use designated professionals to make investment decisions. The AI Bill also directs the SEC to provide AI status to several categories of people based on their professional qualifications.

Based on discussion of the proposed legislation at a hearing on June 16, and according to staff of the legislation's sponsor, revisions to the AI Bill are likely.

SEC Staff Review of the AI Definition

Dodd-Frank requires the SEC to undertake a review of the AI definition in its entirety as it relates to natural persons every four years beginning in 2014. The SEC staff, including the Division of Corporation Finance and the Division of Economic and Risk Analysis, is conducting a comprehensive review of this definition.

The SEC staff has stated that it is considering each of the concepts mentioned in the Executive Summary.

The SEC staff is also considering the AI definition as it applies to entities.

The SEC staff will prepare a report to the SEC describing its review of the AI definition. The SEC will decide whether to make that report public and whether to consider revising the AI definition as a result of this SEC staff review.

SEC Comment letters

Most of the comment letters the SEC has received concerning the possible revision of the definition of AI can be found at www.sec.gov, starting on February 3, 2014. Comment letters at this location before that date mostly deal with the proposed investor protections for Regulation D. As of July 22, 2015, approximately 320 comment letters dealing with the AI definition had been posted at this location.ⁱⁱ Angel investor groups have conducted a coordinated comment letter campaign concerning the SEC's consideration of the AI definition. Most of the comment letters in the SEC's public files are from self-described angel investors, or persons or entities that provide services to or are otherwise associated with angel investors, or the letters contain wording that is substantially similar to angel investor letters. Of the approximately 320 letters relating to the AI definition, approximately 280 appear to be from these types of commenters.ⁱⁱⁱ

While the angel investor community has generated a significant number of comment letters, the SEC staff may be more interested in the concepts being advanced, as opposed to the number of letters supporting a concept.

The SEC's Advisory Committees

The Advisory Committees have considered and made recommendations concerning possible revisions to the AI definition.

Both Advisory Committees have endorsed the concept of adding financial sophistication criteria that would result in AI status without regard to the financial thresholds.

However, the two Advisory Committees took different approaches with regard to the financial thresholds themselves.

The Small Companies Committee recommended that the financial thresholds be adjusted for inflation on a going-forward basis.

The Investor Committee recommended that if the AI definition continues to rely primarily on financial thresholds, new criteria should be added, such as limiting investments in private placements to a percentage of assets or income, or a tiered approach where these restrictions are reduced or eliminated at higher levels of income or assets.

Each of these recommendations is discussed below.

Click [here](#) for access to the recommendations of the Investor Committee.

Click [here](#) for access to the recommendations of the Small Companies Committee.

The AI Financial Thresholds

No Change to the Financial Thresholds

A substantial number of commenters take the view that the SEC should not change the financial thresholds in the AI definition for individuals. The main argument for this position is that the current definition is working and that changing the income or net worth tests would have a material adverse impact on the private placement market.

Most of the comment letters recommend leaving the AI financial thresholds alone because angel investors take this view and the vast majority of the comment letters have been posted by persons associated with or providing services to, or otherwise supporting, angel investor groups.

Adjust the Financial Thresholds for Inflation Going Forward

The Small Companies Committee recommends that the SEC adjust the AI thresholds according to the consumer price index to take into account the effect of future inflation on a going-forward basis. This approach recognizes that the financial thresholds should be modified to reflect changed macro-economic conditions over time, but has the advantage of avoiding the potentially serious negative impact to the private placement market that could take place if the AI financial thresholds were adjusted for inflation since 1982.

A few comment letters also support this concept. However, some of these comment letters advance this idea as an alternative to adjusting the AI financial thresholds for inflation since 1982 or otherwise increasing the AI financial thresholds at the present time. If adjustment for inflation since 1982 is not a probable option, as seems likely, these commenters might prefer to see the AI financial thresholds stay the same. See, for example, Fred Bryant, co-founder and COO, Wealthforge, September 23, 2014, and Randal Klein, Streamline Consulting LLC, June 18, 2014.

Add a Percentage of Income or Net Worth Test

The Investor Committee believes that the current financial thresholds are inadequate.^{iv} However, the Investor Committee did not recommend simply adjusting the AI financial thresholds for inflation since 1982.^v Instead, the Investor Committee recommended consideration of a new approach based on a percentage of income or net worth.

The Investor Committee recommended that the SEC consider alternatives to these thresholds such as the following if the SEC decides to continue with an approach that relies exclusively or mainly on financial thresholds:

- Limiting investments in private offerings to a percentage of assets or income
- A tiered approach, which would allow some investments in privately placed securities once a person reaches an initial threshold based on a percentage of income or assets, with these restrictions being reduced and then eliminated as income or assets rise

As an example of this type of tiered approach, the Investor Committee stated that the SEC could retain the current income and net worth thresholds as the base value for the AI definition, but restrict individuals who meet these thresholds to investing up to 10 percent of their income or net worth in private offerings in the aggregate in a 12-month period. At the same time, the SEC could use the thresholds as adjusted for inflation to define the level above which private offering investments would not be subject to any limits.

However, the Investor Committee noted this possibility for purposes of illustration only, and specifically stated that it was not advocating this approach.

The recommendations of the Investor Committee contain the following statements explaining these concepts.

“Leaving aside the question of whether the financial thresholds are currently set at an appropriate level, the basic “on/off switch” approach seems illogical. A more sensible approach might be to allow some investments in private securities once a person reaches an initial threshold, based on percentage of income or assets, with restrictions being reduced and then eliminated as income or assets rise ...

Properly structured, such an approach to setting the accredited investor definition could significantly reduce the likelihood that investors would suffer unaffordable losses without shrinking the pool of accredited investors in the way that simply adjusting the thresholds for inflation would be likely to do.”

In addition, the Investor Committee believes these approaches could work on a stand-alone basis or in combination with a sophistication or experience standard, as discussed below.

The main disadvantage of this approach is its potential complexity.

A few other commenters have also supported this kind of approach. See, for example, Marilyn Mohrman-Gillis Esq., managing director of public policy and communications, Certified Financial Planner Board of Standards Inc., December 19, 2014, and Mitch Ackles, president, Hedge Fund Association, October 6, 2014. If this kind of test were added in a way that would permit investments as an AI where an individual did not otherwise meet the AI financial thresholds, many commenters probably would support it. See Eric L. Dobson, Ph.D., chief executive officer, Angel Capital Group, July 22, 2014.

In other words, if the concept were used to expand, rather than restrict, the AI class, it might garner support from a wider group of interested persons.

Add a New Financial Sophistication Component

Many commenters recommend that the SEC add a new way for individuals to be treated as AIs without regard to their income or net worth: financial sophistication.

This concept is supported by persons associated with angel investor groups as well as by both SEC Advisory Committees.

Many suggestions have been made concerning the criteria that should be used for this purpose, including:

- professional credentials or professional experience,
- investment experience, or
- passing a test demonstrating financial knowledge.

Professional Qualifications and Designations. Some commenters believe that several types of professional qualifications would necessarily result in sufficient financial literacy to be considered an AI. Commenters have recommended several criteria, including the following:

- Advanced Degrees – Individuals holding advanced degrees in business or law, such as an MBA, J.D., or a master’s or doctorate in finance, economics or business
- Professional Designations – Individuals with professional designations such as a CPA, CFA or CISP
- Securities Licenses – Individuals who hold securities licenses (Series 7, Series 63 etc.)

Some of these criteria are a lot closer to the mark than others.

The Investor Committee notes that two credentials are commonly mentioned as satisfying the AI standard:

- Series 7 securities license
- Chartered Financial Analyst designation

The question is where to draw the line; in other words, if the SEC takes this approach, will the SEC limit the criteria to situations that very clearly demonstrate depth of financial understanding?

As discussed below, the AI Bill introduced in the U.S. Congress, if passed, would direct the SEC to provide AI status for people with certain specified professional qualifications. See Proposed Legislation below.

Professional Experience. In addition to professional credentials, the Investor Committee supports the use of the concept of professional experience to establish AI status.

People who are involved in the investment activity of private investment vehicles are treated as “knowledgeable employees” and are permitted to invest in those private funds without satisfying certain requirements otherwise associated with those private funds. A knowledgeable employee can invest in a private fund exempt from registration as an investment company under Section 3(c)(1) (3(c)(1) Funds) of the Investment Company Act of 1940 (ICA), a fund which cannot have more than 100 beneficial owners, without being counted as a beneficial owner. A knowledgeable employee also can invest in a collective investment vehicle that is exempt from registration as an investment company under section 3(c)(7) of the ICA (a QP Fund), without meeting the financial tests imposed on other investors in a QP Fund.

However, currently, these “knowledgeable employees” are not treated as AIs unless they meet the AI financial thresholds. This disconnect results in the very strange result that a person can be treated as

financially sophisticated under the ICA rules for 3(c)(1) Funds and QP Funds, but not for purposes of the AI definition.

Representatives of the private funds industry have been trying to get this result changed for a long time.

In effect, the Investor Committee has advocated this change and suggested that the knowledgeable employee concept be used as a model for an additional AI category.

Investment Experience. Commenters also have recommended that the SEC consider a new category of AI based on an individual's investment experience.

Investments Owned. A few commenters have advanced the idea that an individual who has a sufficient level of investments should be considered financially sophisticated and qualify as an AI. The Investor Committee supports this concept.

The SEC has used this logic before. The SEC proposed a comparable standard as an alternative method of qualifying as an AI in 2007, but did not adopt the proposal. The proposal would have required \$750,000 in investments, and that standard would have been an alternative to the income and net worth tests for individuals.

The ICA contains a very similar concept. A QP Fund is exempt from registration as an investment company under the ICA if all outstanding securities are owned by "qualified purchasers." An individual who holds \$5 million or more in specified types of investments is considered a qualified purchaser. For the purpose of the 2007 AI proposal, "investments" meant essentially the same types of investments as are required to be a "qualified purchaser" in a QP Fund, although at a lower total amount.

Angel Investors. One of the goals of the angel investor community is to have the AI definition revised so that participation in an angel investor group would automatically result in AI status. The Investor Committee noted that participation in an angel network, in and of itself, may not serve as an adequate measure of financial expertise or experience. However, the Investor Committee stated that it might be possible to develop an acceptable approach to qualifying as an AI based on participation in an angel group that follows best practices with regard to due diligence and that includes financially sophisticated members.

The Investor Committee did not provide specifics as to how this type of arrangement would work in a practical sense.

Passing a Test. Some commenters have recommended that AI status should be available to people who pass a test that demonstrates financial literacy.

Many commenters believe that testing should deal with financial literacy in a general sense, while others argue that testing would need to be very specific, i.e., test knowledge concerning the industry in which the proposed investment would be made.

There has also been discussion about how to design and administer this kind of test.

The Investor Committee noted that it would be possible, at least in theory, to develop a test that individuals could take to qualify as AIs. Such a test could be developed either by the regulators themselves – the SEC working in conjunction with the state securities regulators and FINRA – or it could be developed by an independent party.

One commentator suggested that the SEC should administer the test and keep a central registry of people who have passed it. Many commenters have recommended that the test would need to be acceptable to, and approved by, the SEC.

The AI Bill introduced in the U.S. Congress, if passed, would implement this concept. See Proposed Legislation below.

Acting through a Registered Investment Advisor or Broker-Dealer. Some commenters have recommended AI status for an individual who has consulted a licensed investment expert and acts in accordance with their recommendations. See, for example, Joanna Schwartz, CEO, Early Shares.com Inc., August 4, 2014, and Jerry Verseput, CFP, NAPFA, July 11, 2014.

In addition, the AI Bill, if passed in the U.S. Congress, would implement this concept. See Proposed Legislation below.

Proposed Legislation

Congress is also considering legislation that, if passed, would direct the SEC to expand the AI definition. The proposed legislation is titled Fair Investment Opportunities for Professional Experts Act and is H.R. 2187 (the AI Bill).

Click [here](#) for access to the text of the AI Bill.

Proposed Test to Provide AI Status

The AI Bill calls for the SEC to develop criteria to be used by FINRA to administer a test. Persons passing this test would be licensed by FINRA as AIs. The proposed legislation states that the subjects covered by the test could include:

- the different types of securities,
- the disclosure obligations of public companies as compared to private companies,
- corporate governance structures, and
- the components of a financial statement.

Proposed AI Status for Designated Professionals

The AI Bill also directs the SEC to provide AI status to a natural person who falls within one of the following categories:

- a registered broker-dealer or investment advisor,
- a CPA, or
- an attorney

Use of Designated Professionals to Make Investment Decisions

The AI Bill also directs the SEC to provide AI status to a natural person who retains and uses a registered broker-dealer or investment adviser, CPA or attorney to make an investment decision relative to the securities in question.

Self-Certification

The AI Bill provides that AI status would be based upon a certification to the issuer prior to the sale of securities from the natural person seeking to establish AI status.

June 16 Legislative Hearing

A hearing on the AI Bill was held on June 16, 2015, in the House Financial Services Capital Markets Subcommittee. No representatives of the SEC or FINRA appeared at the hearing.

Two witnesses at the hearing discussed the proposed legislation:

- J. Robert Brown, Professor of Law at the University of Denver Sturm College of Law and Secretary of the Investor Committee
- Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce

Testimony at the June 16 Hearing Concerning the Proposed AI Status Test. With respect to the testing aspect of the legislative proposal, Mr. Brown recommended periodic retesting and the possible addition of more criteria to be covered in the test. Mr. Quaadman stated that before creating a test to establish AI status, it is important to understand the characteristics of and sophistication level that an AI should have. Accordingly, he recommended that the SEC be directed to study the characteristics that make a person financially sophisticated.

Testimony at the June 16 Hearing Concerning Proposed AI Status for Designated Professionals. As is described above, the provisions of the AI Bill would confer AI status for persons certifying that they are within one of the four categories of designated professionals. Mr. Brown suggested that these categories were in some respects too broad and in some respects too narrow. In particular, Mr. Brown indicated that lawyers are not necessarily financially sophisticated.

Mr. Brown also suggested that the proposed legislation leaves out other categories of people who probably are financially sophisticated, such as people who understand financial matters by virtue of education or actual experience. Mr. Brown expressed a concern that if the proposed legislation were adopted as originally written, the SEC might focus on the categories in the legislation and not include other categories of people who would also be considered financially sophisticated.

Mr. Quaadman stated that a registered broker-dealer might be deemed to have a sufficient level of financial sophistication to be considered an AI. He did not comment on the other proposed categories but instead stated that an option would be to cap the level of investments persons in the AI category could make in complex instruments. This concept would tie permitted investments to the ability to withstand losses. (The Investor Committee recommended consideration by the SEC of a similar concept.)

Testimony at the June 16 Hearing Concerning Proposed AI Status for People Who Retain Designated Professionals to Make Investment Decisions. Mr. Brown suggested that the provisions of the AI Bill concerning retention and use of the services of designated professionals also presented a number of issues, including the following:

- The language of the provision is unclear because it does not explicitly provide that the professional must have been retained to provide investment advice with respect to a particular security.
- The provision does not require that the designated professionals have any particular understanding or knowledge with respect to the investment at issue, or that the designated professional believe that the investor understands the investment.
- The provision does not include any disqualifications for designated professionals who have been determined to be bad actors.
- The provision does not include safeguards designed to ensure that investors are adequately protected in their relationship with the specified professional. In contrast, the definition of “Purchaser Representative” in Rule 501 requires that the representative have sufficient knowledge and experience about the prospective investment. In addition, there must be a written acknowledgement of a representative’s status, and the Purchaser Representative must disclose certain conflicts of interest. None of these safeguards is required in the current draft of the AI Bill.
- The categories included in the legislation should be subject to a uniform fiduciary obligation.

Mr. Quadman also expressed concern that this part of the AI Bill might place unsophisticated investors at risk while creating liability for financial intermediaries.

Testimony of the June 16 Hearing Concerning Self-Certification. Concerning self-certification, Mr. Brown suggested that the proposed legislation was inconsistent with the provisions of Rule 506(c), which requires that an issuer take “reasonable steps” to verify AI status. Rule 506(c) permits general solicitation in an offering involving only AIs.

Revisions to Proposed Legislation Likely

According to staff of the sponsor of the AI Bill, revisions to the proposed legislation are being considered, and changes are probable.

ⁱ The SEC’s Investor Advisory Committee included in its recommendations an illustration of a potential approach that included adjusting the financial thresholds for inflation, but was not advocating this illustration as a specific proposal.

ⁱⁱ There are also a few comment letters relating to the potential change of the AI definition on the SEC’s Spotlight page for the Investor Committee (six letters) and the SEC Spotlight page for the Small Companies Committee (seven letters).

ⁱⁱⁱ These figures include form letters supporting angel investor advocated positions relating to the AI definition. The SEC file identifies these form letters by type (Type C, Type D and Type E) and records the total number of letters in each group/type that the SEC received as follows:

- Type C Letters - 48 letters from members of the Angel Capital Association
- Type D Letters - 109 letters expressing agreement with the comment letter by Kiran Lingam at SeedInvest
- Type E Letters - 47 comment letters from members of Golden Seeds, an angel group dedicated to evaluating, funding and helping companies with at least one woman in a management role

Each of the letters in each identified group/type is exactly the same as every other letter in that identified group/type. Type C, D and E letters support leaving the income and net worth tests alone and the Type C and D letters recommend adding a sophistication component.

^{iv} The Investor Committee believes that the current definition's financial thresholds do not adequately reflect investor sophistication, access to information, and ability to withstand losses because:

- non-financial assets (other than the primary residence) are included in the net worth test, and as a result the current AI net worth definition does not guarantee that the individual AI will have sufficient liquid financial assets to ensure either that they can hold privately placed securities indefinitely or that they can withstand a significant loss on those investments;
- many individuals who meet the net worth threshold will do so based on a retirement nest egg that will need to see them through retirement; and
- the income test by itself does not assure that individuals will have significant financial assets and the ability to withstand the potential risks of private offerings among individuals who qualify as AIs based exclusively on income will vary greatly based on a number of factors not addressed by the current AI definition.

^v The Investor Committee stated that it did not recommend adjusting the AI thresholds for inflation because:

- it is not clear that the SEC set the initial financial thresholds at the right levels in 1982,
- adjusting the AI definition thresholds for inflation would significantly restrict the pool of capital available for private offerings, and
- raising the AI financial thresholds would not resolve the shortcomings in the current AI definition.