# Accreditation & Suitability

## Why each must be considered before making an Alternative Investment

By Bruce B. Smith

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# Summary

Investing in alternative investments is becoming easier and easier to do — just go to any crowdfunding site and throw a dart at one of the many deals on the screen.

It's easy unless you also want to consider your investment time horizon, your level of risk tolerance and other very important personal issues you should be contemplating when making an investment — of any type. Lower investment minimums and a burgeoning number of websites offering alternative investments enable investors to "leap before they look" — to invest before they fully understand whether the investment is appropriate for them.

**The onus, in these cases, is solely on the investor ... caveat emptor!**

This White Paper reviews two aspects every prudent investor in "Regulation D" and other forms of alternative investments must address ***before writing the check — Accreditation and Suitability.*** For some reason, Suitability doesn't seem to be a part of the crowdfunding conversation, even though it's fundamental to investing!

After 20+ years working with wealthy individual investors and placing over $1 billion of private debt and equity securities, Carolina Financial Securities, Carofin's parent company, has strong opinions about suitability which we'd like to share with you before you make your next investment — with Carofin or otherwise.

We hope that this helps you understand why we take a thoughtful approach as we register new investors with Carofin — before they make an investment with us — and why we then continually update their investment profiles. We suggest that you hit the PAUSE button when others trying to sell you a security don't first get to know you better.

# Accreditation Defined

You've probably heard about the need to be "Accredited" before you can participate in certain investments known as "Reg D" offerings. Adopted in 1982, Regulation D specifies the Securities and Exchange Commission's (S.E.C.) guidelines for conducting private securities transactions in the United States.

Within Reg D, there are "Rules" for different types of private placements, as well as rules governing the types of investors allowed to participate (Rule 501). In other words, these offerings are limited to persons of greater financial means who can better withstand the potential losses associated with riskier investments.

Relatively new U.S. securities laws (the Jobs Act of 2012 and the related Securities and Exchange Commission regulations in 2016) allow certain Reg D offerings to advertise ("general solicitation" in regulatory-speak). But these can only be sold to Accredited Investors after the Issuer takes "reasonable steps" to verify an investor's accreditation, which is usually satisfied by third-party verification of an investor's financial status (e.g., verified by tax returns, bank statements, credit reports or by an accountant, lawyer or banker).

## Who is an Accredited investor?

*An "Accredited" individual[1] is anyone who:*

- Earned income exceeding $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).

While these criteria are legally required for certain types of investment by individuals, ***Accreditation alone is not sufficient to protect you*** — that's where ***Suitability plays an important role.***

*[1] For more detailed information, please go to the SEC's website here. The SEC goes on to list additional types of accredited investors and explains how to calculate your net worth.*

# Suitability Defined

Speaking broadly, suitability encompasses: *"the quality of being right or appropriate for a particular person, purpose, or situation."* As it relates to investment selection, Suitability means that the following considerations are continually evaluated and a determination is made whether or not an investment is appropriate for the investor:

- Age (riskier investments should generally be avoided later in life);
- Other investments (their liquidity, industry concentration, potential performance, etc.);
- Financial situation and needs, which might include questions about a person's annual income and liquid net worth;
- Tax status, such as marginal tax rate;
- Investment objectives, which might include generating income, funding retirement, buying a home, preserving wealth or market speculation;
- Investment experience;
- Investment time horizon, such as the expected time available to achieve a particular financial goal;
- Liquidity needs, which is the investor's need to convert investments to cash without incurring significant loss in value; and
- Risk tolerance, which is a customer's willingness to risk losing some or all the original investment in exchange for greater potential returns.

So while Accreditation applies to Reg D offerings — private placements, or now some publicly available offerings — suitability is relevant to all forms of investment ... certainly including crowdfunding and other forms of alternative investment. If the placement agent for an offering is a registered Broker-Dealer such as Carofin, Suitability is a requirement!

# For alternative investments, suitability encompasses other areas:

- **Greater Risk:** Is the investor fully aware of the inherent risk of loss involved with illiquid, private securities? If so, do investments in often fragile, private companies match their levels of risk tolerance?
- **Illiquidity:** Does the investor need to convert the investment back to cash (i.e., sell it) before the end of its life cycle? Many alternative investments, particularly private placements, do not have an active secondary market within which the investor can sell the security before it matures or otherwise reaches a "liquidity event."
- **Motivation:** What are the investor's reasons for considering alternative investments? Often the answer is the volatility of the public markets and desire for non-correlated, "absolute return" investments.
- **Investment Experience:** Have they previously invested in private placements? Have these investments worked out? Realizing that most such investments are in private companies, the risks are substantial.
- **Due Diligence:** Is the investor prepared to commit the time and effort required to know whether the offering is a good fit for them?

**FOR MORE INFORMATION ABOUT DUE DILIGENCE**
(click to read the following related articles)

- **"Due Diligence" and Investments: What do I really need to know?**
- **"Red Flags in Due Diligence"**
- **"Due Diligence for Private Business Investment Opportunities"**

# Suitability determination is legally required...or not!

FINRA, the self-regulatory organization for the U.S. securities industry, provides clear guidelines regarding suitability for broker-dealers.

FINRA Rule 2111 *"Requires that a firm or associated person have a reasonable basis to believe a* ***recommended transaction*** *or investment strategy involving a security or securities is suitable for the customer. Brokers must have a firm understanding of both the product and the customer."*

Therefore, a FINRA-registered broker-dealer collects and maintains extensive investor records, expending significant resources to ensure that its investors are suitable.

Unfortunately, ***many crowdfunding sites are not permitted to recommend transactions, and therefore, are not subject to suitability requirements.*** Hopefully this will change over time because Carofin believes suitability considerations are particularly important for investors engaged in crowdfunding.

Whether you work with a broker-dealer, a financial advisor or go at it alone, understanding your unique situation, investment profile, need for liquidity, etc., is essential to protecting yourself.

# How Carofin approaches investor suitability

We feel that suitability must still be initially determined through a phone call between one of our investment professionals and each investor who is new to us.

## Profile, Experience, and Investment Preferences

The conversation is likely to cover the following:

- A review of the items described above to develop a more comprehensive understanding of the investor's circumstances.
- The current investment portfolio - how diversified is it? How much is already invested in alternatives?
- What are the investor's return preferences so we can present deals which best align with their stated interests.
- Current income (debt investments) or capital gains (equity investment)? If current income, what's driving this interest? If equity, can they afford to be patient? Also, can they assume higher risk (generally higher potential return) and are early stage ventures or more mature, growth company investments more appropriate?
- Maturity time horizon? Does the investor only want to see short-term debt with maturities less than three years? Or are they willing to invest in something that may take 5 years, 10 years or longer to return principal?
- Are there particular industries that interest them, or, conversely, are there industries that they would rather avoid?

Someone who has been investing in private securities for years probably understands a bit about the many different forms of these investments, e.g., senior notes, convertible notes, royalty notes, participating preferred equity, etc. They probably understand that money invested in these vehicles should be categorized as high risk and that they may lose some or all their invested capital.

A telephone conversation between one of our investment professionals and an investor will usually confirm whether they do or don't appreciate the risks they are taking through our typical offerings.

## Please use Carofin's Knowledge Base

In the past, much of the information needed to make an informed alternative investment decision has been very difficult to find.  These securities have historically been in the realm of highly specialized professional investors (private funds, insurance companies, etc.).

For this reason, we have created our Knowledge Base - a free, online and growing collection of educational materials specific to alternative investment – created by Carofin with contributions from other investment professionals we respect.  Here you can find what goes into evaluating a company, what's involved in conducting in-depth due diligence, sample Term Sheets for better understanding highly structured securities, a Glossary of Investment Terms and much more (we've made it simple to find subjects with our "Search" bar).

## About the Author:

## BRUCE SMITH, MANAGING DIRECTOR

After twenty years on Wall Street, Bruce joined CFG in 2012 and spends most of his time working with new investors to Carofin, introducing them to the Knowledge Base and helping them gain access to Carofin's Alternative Investment Marketplace. In addition, he enjoys writing articles for Carofin's LinkedIn page and introduces appropriate investment opportunities to new investors.

**If you like reading these papers and want to stay current, please "Follow us" on LinkedIn.**

**As always, please reach out to schedule a call if you have questions. (828.393.5401)**

**Or, if you'd like to learn more about our current offerings, register here.**

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