US Securities and Exchange Commission (SEC) expands accredited investor definition

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Abstract

Purpose – *To explain amendments to the definition of "accredited investor" approved by the SEC in August 2020 and to describe the impact of the changes.*

Design/methodology/approach – *Explains how the amendments expand the pool of qualified investors in various subsections of the definition, explains related amendments, and then discusses the implications of the changes.*

Findings – *The amendments, among other things: (i) permit natural persons to qualify as accredited investors based on certain professional credentials or, for investments in private funds, based on "knowledgeable employee" status"; (ii) add LLCs and other specified entity types to the list of potentially-qualifying entities, and add a "catch-all" category for unspecified entities (although with different quantitative standards); (iii) add the term "spousal equivalent" to the definition; and (iv) codify certain related staff interpretive positions. In addition, the amendments revise the definition of "qualified institutional buyer" to include additional entity types to avoid inconsistencies with the new accredited investor definition.*

Originality/value – *Expert analysis and guidance from experienced securities attorneys who counsel clients on all manner of SEC regulatory policy matters.*

Keywords *US Securities and Exchange Commission (SEC), Accredited investor, Private fund investments, Qualified institutional buyer, Regulation D of the Securities Act of 1933, Rule 144A of the Securities Act of 1933*

Paper type *Technical paper*

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On August 26, 2020, the SEC approved Amendments (available at: www.sec.gov/rules/final/2020/33-10824.pdf) to the definition of "accredited investor." This definition is a central component of several exemptions from Securities Act of 1933 (Securities Act) registration, including Rules 506(b) and 506(c) of Regulation D, and plays an important role in other federal and state securities law contexts. Qualifying as an accredited investor is significant because accredited investors may participate in investment opportunities that are generally not available to non-accredited investors, including certain investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds. The Amendments become effective 60 days after publication in the Federal Register.

As discussed more fully below, the Amendments, among other things:

- permit natural persons to qualify as accredited investors based on certain professional credentials or, with respect to investments in private funds, based on the person's status as a "knowledgeable employee" of the fund;
- add limited liability companies and other specified entity types to the list of entities that may qualify as accredited investors, and add a "catch-all" category for unspecified entities that may qualify (although with different quantitative standards);

- add the term "spousal equivalent" to the accredited investor definition; and
- codify certain related staff interpretive positions.

In addition, the Amendments revise the definition of "qualified institutional buyer" in Securities Act Rule 144A to include additional entity types that meet the $100 million threshold to avoid inconsistencies between the types of entities that are eligible for accredited investor status and those that are eligible for qualified institutional buyer status under Rule 144A.

Professional Certifications

The Amendments expand the definition of accredited investor to include natural persons holding one or more professional certifications or designations or other credentials that the SEC designates by order from time to time. The Amendments include a non-exclusive list of attributes that the SEC will consider in determining which professional certifications and designations or other credentials qualify a natural person for accredited investor status. Initial recognized certifications and designations are:

- Licensed General Securities Representative (Series 7);
- Licensed Investment Adviser Representative (Series 65); and
- Licensed Private Securities Offerings Representative (Series 82), each as administered by the Financial Industry Regulatory Authority Inc. (FINRA).

Where applicable, an individual would be required to maintain an active certification, designation, or credential, but would not be required to practice in such fields, except to the extent that continued affiliation with a firm is required to maintain the certification, designation, or credential. Accredited educational institutions, self-regulatory organizations, or other industry bodies may apply to the SEC for consideration as a qualifying professional certification or designation or credential (members of the public may also propose inclusion of a specific degree or program of study). Currently-recognized credentials will be posted on the SEC's website. Notice and an opportunity for public comment will be provided before a final order is issued with respect to future designations.

Knowledgeable Employees

The Amendments add "knowledgeable employees" of a private fund to the definition of accredited investors for investments in the fund. This new category refers to Rule 3c-5(a)(4) of the Investment Company Act of 1940 (Investment Company Act), which defines a "knowledgeable employee" with respect to a private fund as:

- an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person (as defined in Rule 3c-5(a)(1)) of the private fund; and
- an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such private fund, other private funds, or investment companies the investment activities of which are managed by such affiliated management person of the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

Consistent with definitions under the Investment Advisers Act of 1940, as amended (Advisers Act), "private funds" are issuers that would be an "investment company" under the Investment Company Act, but for the exclusions provided under Sections 3(c)(1) and 3 (c)(7) thereunder.

Under Rule 501(a)(8), private funds with assets of $5 million or less may qualify as accredited investors if all of the fund's equity owners are accredited investors. The Amendments will allow these small private funds to accept investments from knowledgeable employees without jeopardizing their status as accredited investors under Rule 501(a)(8) and their ability to participate in certain offerings under Rule 506 in which they would not otherwise be eligible to participate.

Joint Net Worth

The Amendments expand the concept of "joint net worth" for purposes of the accredited investor definition to permit aggregation with an investor's spouse or spousal equivalent (cohabitant occupying a relationship generally equivalent to that of a spouse)—the definition was formerly limited to aggregation with a spouse—and clarifies that the securities being purchased under the joint net worth test need not be purchased jointly.

Entities

The accredited investor definition includes enumerated categories of entities in paragraphs (1) through (3), (7), and (8) of Rule 501(a).The Amendments revise Rule 501(a)(1) to include investment advisers registered under Section 203 of the Advisers Act or registered under the laws of the various states (including those that are sole proprietorships), exempt reporting advisers under Section 203 (l) or (m) of the Advisers Act, and rural business investment companies (RBICs). The Amendments revise Rule 501(a)(3) to include limited liability companies in the list of entities that qualify as accredited investors if they have total assets in excess of $5 million and were not formed for the specific purpose of acquiring the securities being offered.

The Amendments add Rule 501(a)(9), which expands the accredited investor definition to include any entity of a type not covered elsewhere in Rule 501(a) that is not formed for the specific purpose of acquiring the securities being offered. Unlike the specified entities in Rule 501(a)(3), these other types of entities would qualify on the basis of investments, not total assets, in excess of $5 million. The Amendments incorporate the definition of investments from Rule 2a51-1(b) under the Investment Company Act, which includes, among other things: securities; real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents. The term "entity" is broad, and is intended to encompass other types of entities not otherwise specifically listed, including Indian tribes and the divisions and instrumentalities thereof, federal, state, territorial, and local government bodies, funds, and entities organized or under the laws of foreign countries.

The Amendments also add "family offices" (as defined in the SEC's family office rule) with at least $5 million in assets under management (new Rule 501(a)(12)), and its "family clients" (new Rule 501(a)(13)) to the accredited investor definition. To qualify, the prospective investment must be directed by a person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of such investment. In addition, the family office could not have been formed for the specific purpose of acquiring the securities offered.

Under Rule 501(a)(8), an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors. Because an equity owner of an entity may be another entity, the Amendments clarify that, in determining accredited investor status under Rule

501(a)(8), one may look through various forms of equity ownership to the ultimate natural person owners.

Related Amendments

The Amendments revise the accredited investor definition in Securities Act Rule 215 (related to the small offering exemption) to conform to the accredited investor definition in amended Rule 501(a).

Pursuant to Securities Act Rule 163B, an issuer may engage in test-the-waters communications with potential investors that are, or that the issuer or person authorized to act on its behalf reasonably believes are, qualified institutional buyers or institutions that are accredited investors as defined in Rule 501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8). Rule 163B has been amended to include institutions that are accredited investors defined in Rules 501 (a)(9), (12) and (13).

Broker-dealers are required to disclose certain specified information to their customers prior to effecting a transaction in penny stocks. Previous Exchange Act Rule 15g–1 exempts transactions from these disclosure requirements if the customer is an institutional accredited investor, as defined in Rule 501(a)(1), (2), (3), (7), or (8). Rule 15g-1(b) has been amended to include a reference to new Rules 501(a)(9), (12) and (13).

Qualified Institutional Buyers

Rule 144A provides a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales to qualified institutional buyers of certain restricted securities. The Amendments expand the qualified institutional buyer definition by adding RBICs to Rule 144A(a)(1)(i)(C) and limited liability companies to Rule 144A(a)(1)(i)(H). Further, to ensure that entities that qualify for accredited investor status may also qualify for qualified institutional buyer status when they meet the $100 million in securities owned and invested threshold in Rule 144A(a)(1)(i), the Amendments add new paragraph (J) to Rule 144A(a)(1)(i) to permit institutional accredited investors under Rule 501(a), of an entity type not already included in paragraphs 144A(a)(1)(i)(A) through (I) or 144A(a)(1)(ii) through (vi), including Indian tribes, governmental bodies, and bank maintained collective investment trusts, to qualify as qualified institutional buyers when they satisfy the $100 million threshold. Unlike Rule 501(a), however, Rule 144A(a)(1)(i)(J) clarifies that the entity seeking qualified intuitional buyer status under that section may be formed for the purpose of acquiring the 144A securities being offered.

Impact of the Amendments

The Amendments are intended to more effectively identify institutional and individual investors that have the knowledge and expertise to participate in private capital markets. As noted by SEC Chairman Jay Clayton in a statement, as result of the Amendments, “For the first time, individuals will be permitted to participate in private capital markets not only based on their income or net worth, but also based on established, clear measures of financial sophistication.” As certain commenters to the proposed amendments pointed out, because more financially sophisticated investors who do not otherwise meet the income or net worth tests will now be considered accredited investors, there may be a greater risk that some newly accredited investors may invest in private investments where they are less able to financially bear the risk of loss posed by such investments. Issuers and private fund managers may want to consider whether to continue to assess the financial stability of all of their prospective investors, particularly given the typical limitations on transferability and illiquid nature of unregistered securities.

It will take some time for the ultimate effects of these Amendments on the private capital markets to be seen. While private funds that rely on the Section 3(c)(7) exclusion under the Investment Company Act will still need to continue to ensure that their investors remain qualified purchasers, private funds that rely on the Section 3(c)(1) exclusion, in which investors need only be accredited investors, may find that they have additional prospective investors from which to raise capital (subject to investor limits under that exclusion). Companies and private fund managers should be mindful that the Amendments do not change the requirements for private placements under Regulation D, so they should continue to limit their offering methods accordingly.

The Amendments also expand and update the list of entities that may qualify for accredited investor status, including tribal governments and other organizations under the new "catch-all" category based on investments (instead of assets). This should create more certainty for companies and funds raising capital with respect to potential participants for certain private offerings, and more opportunity (and less headache) for investors who do not fit into the specifically enumerated categories of the definition. However, the addition of "spousal equivalents" to joint net worth and income determinations may create uncertainty for companies and funds subject to the independent verification requirements of Rule 506 (c) if an investor proposes to treat an individual in an other-than-legally-recognized union as a spousal equivalent.

Managers of private funds will need to ensure that they update their subscription and other investor application materials to take into account the new accredited investor categories, either before raising their next closed-end fund or in order to accept new accredited investor subscribers into an existing open-end structure. Both companies and fund managers may also want to take this time to update their requirements for investments by knowledgeable employees to reflect the changes and clarifications provided by the new Amendments.

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