ALERT

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SEC Expands Universe of "Accredited Investors"

An expanded universe of individuals and entities will be able to participate as "accredited investors" in securities offerings as a result of recent SEC rulemaking.

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TAKEAWAYS

- The SEC has expanded its definition of "Accredited Investor" to additional individuals and entities, including individuals with certain professional certifications and knowledgeable employees of private funds.
- The amendments may provide additional regulatory certainty for issuers, investors and counsel.

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On August 26, 2020, the Securities and Exchange Commission (the SEC) adopted amendments to the definition of "accredited investor" in Rule 501(a) of Regulation D under the Securities Act of 1933 (the Amendments). The Amendments, which will become effective 60 days after they are published in the Federal Register, expand the pool of individuals and entities that qualify as accredited investors. The definition of accredited investor is relevant, among other things, to the operation of Rule 506 of Regulation D, which is a safe harbor under Section 4(a)(2) of the Securities Act. Rule 506 is the most commonly-used exemption for private offerings, accounting for the vast majority of the trillions of dollars raised through unregistered offerings every year. Unregistered, private offerings of securities have supplanted public offerings as the dominant form of capital-raising in the United States. Since regulatory requirements are much greater for offerings that include non-accredited investors, an overwhelming majority of Rule 506 offerings are offered only to accredited investors.

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The tests that must be met for individuals to qualify as accredited investors have remained virtually unchanged since the adoption of Regulation D over 35 years ago, and are predominantly based on an individual's income and net worth. Inflation has gradually eroded the significance of this proxy for investor sophistication—in 1983, less than 2 percent of U.S. households qualified as accredited investors, while 30 years later, over 10 percent of U.S. households could meet the definition. However, since Regulation D's adoption, there has been dissatisfaction with using income and wealth as the sole means of judging an investor's sophistication and ability to evaluate risks. The SEC's adoption of new, knowledge-based criteria for qualification represents a significant step forward in broadening the pool of individuals who are accredited investors.

The SEC is expanding the definition of "accredited investor" in Rule 501(a) to include the following:

- any entity that owns investments in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered;
- any investment adviser registered under federal or state law (and Exempt Reporting Advisers relying on Section 203(m) or 203(l) of the Investment Advisers Act of 1940);
- any rural business investment company (RBIC);
- any individual who has a professional certification, designation or credential from an accredited educational institution that the Commission designates as qualifying for accredited investor status;
- any individual who is a "knowledgeable employee" of a "private fund," which is defined to include an issuer that would be an investment company, but for the exclusions provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;
- any family office with at least $5 million in assets under management and that was not formed for the specific purpose of acquiring the securities offered, and whose investment is directed by a person capable of evaluating the merits and risks of the prospective investment; and
- any family client of a family office described in the prior bullet point whose prospective investment is directed by that family office.

The SEC is also clarifying in Rule 501(a) its long-standing position that limited liability companies with $5 million in assets and not formed for the specific purpose of acquiring the securities offered qualify as accredited investors.

The SEC is also amending Rule 501(a) so that a "spousal equivalent" (defined as a cohabitant occupying a relationship generally equivalent to that of a spouse) is treated the same as a spouse under Rule 501(a).

See Annex A to this client alert for a redlined comparison that shows the changes being made by the SEC to the definition of "accredited investor" in Rule 501(a).

The SEC is also making similar changes to the following SEC rules:

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- Rule 144A under the Securities Act to expand the definition of "qualified institutional buyer" (QIB) to include RBICs, limited liability companies and any other institutional accredited investors, in each case that satisfy the $100 million threshold for QIBs;
- Rule 163B under the Securities Act to encompass the new categories of institutional accredited investors;
- Rule 215 under the Securities Act to define accredited investor to track Rule 501(a); and
- Rule 15g-1 under the Securities Exchange Act of 1934 to encompass the new categories of institutional accredited investors.

Qualifying Credentials

As discussed above, individuals with certain professional certifications, designations or other credentials will now qualify as accredited investors under Rule 501(a)(10). The qualifying professional certifications, designations and other credentials will be designated by the SEC from time to time. Initially, the SEC has designated for qualification the following three FINRA-established professional certifications:

1. the General Securities Representative license (Series 7);
2. the Licensed Investment Adviser Representative (Series 65); and
3. the Private Securities Offerings Representative license (Series 82).

Prior to designating any new professional certifications, designations or credentials for qualification under Rule 501(a)(10), the SEC will provide notice and opportunity for public comment. A current list of the qualifying credentials will be maintained on the SEC's website.

While the holder of the qualifying certification, designation or credential is not required to practice in the related fields, the SEC will require that the holder maintain the certification, designation or credential in good standing.

Knowledgeable Employees of Private Funds

The Amendments add a new category to the accredited investor definition under Rule 501(a)(11) to cover "knowledgeable employees" of a private fund. This category will cover the same individuals that are included in the definition of "knowledgeable employee" in Investment Company Act Rule 3c-5(a)(5) and includes, among other persons, trustees and advisory board members of a private fund or an affiliated person of the private fund that oversees the private fund's investments, as well as employees of the private fund or the affiliated person of the private fund who, in connection with the employees' regular functions or duties, have participated in the investment activities of such private fund for at least 12 months.

Prior to the Amendments, employees of private funds that have assets of $5 million or less were often restricted from investing in the private fund due to the fact that, under Rule 501(a)(8), such a private fund, itself, may qualify as an accredited investor only if all of the private fund's equity owners, themselves, are

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accredited investors. By including knowledgeable employees in the definition of accredited investor, such employees may invest in the private fund without the private fund itself losing accredited investor status when the private fund has assets of $5 million or less.

Implications and Effects of Amendments

The inclusion of knowledgeable employees as accredited investors will remove a recurring issue that arises when issuers want to permit employees to participate in offerings, but cannot offer their securities to employees who are not accredited investors or to groups that include employees who are not accredited investors. This single change may be the one most appreciated by companies that make offerings pursuant to Rule 506.

The inclusion of securities professionals with FINRA-based certifications also avoids uncomfortable situations in which securities professionals, who may know more about an offering than any investors, are unable to invest themselves.

The SEC’s action is welcome and responds to longstanding criticisms of the definition of investor accreditation. The expanded definition also brings the rule closer to long-standing U.S. Supreme Court jurisprudence as to the proper scope of Section 4(a)(2) of the Securities Act (see, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953)). Significantly, issuers can now consider whether certain private offerings that would previously have been “naked” 4(a)(2) offerings (i.e., outside the safe harbor afforded under Regulation D and Rule 506) can now be properly made in compliance with Rule 506 as a result of the Amendments. In this way, the Amendments may well provide additional regulatory certainty for issuers, investors and counsel.

Further, the expanded definition may have the effect of expanding the opportunities for investors to participate in private funds and the investment opportunities that private funds are established to seek. Historically, sophisticated (but not accredited) investors have been restricted in their ability to invest in private funds because their offerings are limited to accredited investors. As a result, many sophisticated investors seeking to make “fund” investments could only do so in funds offered pursuant to registered securities offerings (for example, mutual funds). The wealth test for accreditation presumed that those who had wealth were smart enough to fend for themselves in investing in private funds, but those who were sophisticated and well-educated on the subject of private funds were not.

As a practical matter, issuers (including private funds), investors, financial advisers, investment advisers and counsel need to look to their documentation for new and ongoing offerings to make sure that the requirements for accreditation are properly updated. Investor questionnaires and subscription documents usually repeat the rule-based tests, rather than simply asking if an investor is an accredited investor, so revision of the questionnaires and other documents will be necessary to take advantage of the changes.

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Market participants (including private funds) also need to revisit restrictions on resales of securities purchased in Rule 506 offerings in order to permit resales of those securities to the broader population of accredited investors.

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ANNEX A

Amendments to Rule 501(a) of Regulation D

(a) ***Accredited Investor.*** "*Accredited investor*" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any investment adviser registered pursuant to section 203 of the Investment Advisers Act of 1940 or registered pursuant to the laws of a state; any investment adviser relying on the exemption from registering with the Commission under section 203(l) or (m) of the Investment Advisers Act of 1940; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any Rural Business Investment Company as defined in section 384A of the Consolidated Farm and Rural Development Act; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, ~~or~~ partnership, or limited liability company, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, exceeds $1,000,000~~.~~;

(i) Except as provided in paragraph (a)(5)(ii) of this section, for purposes of calculating net worth under this paragraph (a)(5):

(A) The person's primary residence shall not be included as an asset;

(B) Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and

(C) Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability;

(ii) Paragraph (a)(5)(i) of this section will not apply to any calculation of a person's net worth made in connection with a purchase of securities in accordance with a right to purchase such securities, provided that:

(A) Such right was held by the person on July 20, 2010;

(B) The person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and

(C) The person held securities of the same issuer, other than such right, on July 20, 2010.

Note 1 to paragraph (a)(5): For the purposes of calculating joint net worth in this paragraph (a)(5): joint net worth can be the aggregate net worth of the investor and spouse or spousal equivalent; assets need not be held jointly to be included in the calculation. Reliance on the joint net worth standard of this paragraph (a)(5) does not require that the securities be purchased jointly.

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); ~~and~~

(8) Any entity in which all of the equity owners are accredited investors~~.~~;

Note 1 to paragraph (a)(8): It is permissible to look through various forms of equity ownership to natural persons in determining the accredited investor status of entities under this paragraph (a)(8). If those natural persons are themselves accredited investors, and if all other equity owners of the entity seeking accredited investor status are accredited investors, then this paragraph (a)(8) may be available.

(9) Any entity, of a type not listed in paragraphs (a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), not formed for the specific purpose of acquiring the securities offered, owning investments in excess of $5,000,000;

Note 1 to paragraph (a)(9): For the purposes this paragraph (a)(9), "investments" is defined in rule 2a51-1(b) under the Investment Company Act of 1940 (17 CFR 270.2a51-1(b)).

(10) Any natural person holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution that the Commission has designated as qualifying an individual for accredited investor status. In determining whether to designate a professional certification or designation or credential from an accredited educational institution for purposes of this paragraph (a)(10), the Commission will consider, among others, the following attributes:

(i) The certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution;
(ii) The examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;
(iii) Persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and
(iv) An indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable;

Note 1 to paragraph (a)(10): The Commission will designate professional certifications or designations or credentials for purposes of this paragraph (a)(10), by order, after notice and an opportunity for public comment. The professional certifications or designations or credentials currently recognized by the Commission as satisfying the above criteria will be posted on the Commission's website.

(11) Any natural person who is a "knowledgeable employee," as defined in rule 3c-5(a)(4) under the Investment Company Act of 1940 (17 CFR 270.3c-5(a)(4)), of the issuer of the securities being offered or sold where the issuer would be an investment company, as defined in section 3 of such act, but for the exclusion provided by either section 3(c)(1) or section 3(c)(7) of such act;
(12) Any "family office," as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1):
(i) With assets under management in excess of $5,000,000,
(ii) That is not formed for the specific purpose of acquiring the securities offered, and
(iii) Whose prospective investment is 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 the prospective investment; and
(13) Any "family client," as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1)), of a family office meeting the requirements in paragraph (a)(12) of this section and whose prospective investment in the issuer is directed by such family office pursuant to paragraph (a)(12)(iii).