

12 / 23 / 19

SEC Proposes Amendments To Expand Accredited Investor Definition

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On December 18, 2019, the Securities and Exchange Commission (SEC) proposed amendments to expand the definition of “accredited investor” in Rule 501(a) of Regulation D. The proposed amendments would allow more investors to participate in private offerings by adding new categories of individuals who may qualify as accredited investors based on their professional knowledge, experience or certifications. The proposed updates also would expand the list of entities that may qualify as accredited investors by, among other things, allowing any entity that meets an investment test, rather than an asset test, to qualify.

To conform with the proposed accredited investor definition, additionally the SEC proposed amendments to expand the definition of “qualified institutional buyer” (QIB) in Rule 144A of the Securities Act of 1933, as amended (Securities Act).

The proposal will be open to public comment for 60 days after it is published in the Federal Register.

Background

Under existing SEC rules, certain sophisticated investors, such as accredited investors and QIBs, may participate in investment opportunities that are not generally available to the public and are often regarded as bearing more risk, such as investments in private companies and offerings by certain hedge funds, private equity funds and venture capital funds. In particular, qualifying as an accredited investor under Rule 501(a) of Regulation D is key to a number of exemptions from registration, such as Rules 506(b) and 506(c) of Regulation D.¹

Many investors, practitioners and regulators have long sought to modernize the accredited investor definition, which has remained nearly unchanged since its adoption in 1982. Recognizing this, in December 2015, an [SEC staff report](#) examined the history of the accredited investor definition and considered comments and recommendations on amending it. In June 2019, the SEC issued a [concept release](#) that solicited public comment on ways to simplify, harmonize and improve the exempt offering framework under the Securities Act to promote capital formation and to expand investment

¹ Rule 506 of Regulation D provides an exemption from registration to companies that sell their securities to accredited investors. Currently, an accredited investor is defined as (i) an individual with more than \$1 million in net worth (excluding the value of any primary residence) or who has earned more than \$200,000 per year in each of the last two years, (ii) an organization with more than \$5 million in assets, or (iii) a bank, institution or other entity that meets certain legal criteria.

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opportunities while maintaining appropriate investor protections. Feedback sought included possible approaches to amending the accredited investor definition. The current proposed amendments reflect these considerations.

Commenting on the proposed changes, SEC Chairman Jay Clayton noted that “[t]he current test for individual accredited investor status takes a binary approach to who does and does not qualify based only a person’s income or net worth” and that “[m]odernization of this approach is long overdue.”²

Highlights

Professional Certifications and Designations and Other Credentials

The proposed amendments would add a new category for individuals to qualify as accredited investors based on possession of certain professional certifications and designations or other credentials that demonstrate a background and understanding in the areas of securities and investing, such as a Series 7, 65 or 82 license. An individual would be required to maintain these certifications, designations or credentials in good standing in order to qualify for accredited investor status.

Qualifying criteria would be recognized by means of an SEC order, giving the SEC the flexibility to evaluate criteria on an ongoing basis. While the proposing release does not contain much detail about how this process would operate, the SEC noted that it generally would provide public notice and an opportunity for public comment before issuance of such an order.

Knowledgeable Employees of Private Funds

The proposed amendments would add a new category to the accredited investor definition for individuals that would enable “knowledgeable employees” of a private fund to qualify as accredited investors for investments in the fund.

A “knowledgeable employee” under the proposed amendment would have the same definition as in Rule 3c-5(a)(4) of the Investment Company Act. This group would include, among other persons: (i) executive officers, directors, trustees, advisory board members or persons serving in a similar capacity of a Section 3(c)(1) or 3(c)(7) fund or affiliated persons of the fund that oversee the fund’s investments; as well as (ii) employees or affiliated persons of the fund (other than employees performing solely clerical, secretarial or administrative functions) 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.

² <https://www.sec.gov/news/press-release/2019-265>

Expansion of Certain Entities

The proposed amendments would recognize the following entities as accredited investors:

- Investment advisers registered under Section 203 of the Investment Advisers Act and investment advisers registered under the laws of the various states;
- Limited liability companies that satisfy the other requirements of the accredited investor definition; and
- Rural business investment companies (RBICs).³

Additionally the proposed amendments would add a catch-all provision to qualify any entity, including Native American tribes, that was not formed for the specific purpose of acquiring the securities being offered but that owns “investments” as defined in Rule 2a51-1(b) under the Investment Company Act in excess of \$5 million.

Family Offices and Family Clients

The proposed amendments would add a new category to the accredited investor definition for a “family office” with at least \$5 million in assets under management and for its “family clients,” each as defined in the “family office rule” set forth in Investment Advisers Act Rule 202(a)(11)(G)-1. The amendments would apply only to a family office whose purchases are directed by a person who has such knowledge and experience in financial and business matters that the family office is capable of evaluating the merits and risks of the prospective investment.

Clarifying Amendments

The proposed amendments would add the term “spousal equivalent” to the accredited investor definition when calculating joint income under Rule 501(a)(6), and would include spousal equivalents when determining net worth under Rule 501(a)(5), so that both spouses and spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

In another proposed clarification, the SEC will address equity ownership. Currently 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 in some instances an equity owner of an entity is another entity rather than a natural person, the SEC has proposed to add a note to Rule 501(a)(8) that would specify that, in determining accredited investor status under Rule 501(a)(8), one may look through various forms of equity ownership to evaluate natural person accreditation.

³ A RBIC is defined in Section 384A of the Consolidated Farm and Rural Development Act as a company that is approved by the Secretary of Agriculture and that has entered into a participation agreement with the U.S. Department of Agriculture.

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QIBs

Rule 144A provides a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain restricted securities to QIBs. In response to investor concerns and to avoid inconsistencies between the entity types that are eligible for accredited investor status and QIB status, the SEC has proposed to expand the QIB definition by making conforming changes to Rule 144A, including adding RBICs and limited liability companies to the list of entities covered by Rule 144A.

Further, to ensure that entities which qualify for accredited investor status may also qualify for QIB status when they meet the Rule 144A(a)(1)(i) threshold requiring \$100 million in

owned and invested securities, the SEC is proposing a new paragraph (J) to Rule 144A(a)(1)(i) permitting certain institutional accredited investors to automatically qualify as QIBs when they satisfy the dollar-amount threshold. This new QIB category would reflect the “catch-all” category in the proposed accredited investor definition for entities owning investments in excess of \$5 million that are not formed for the specific purpose of acquiring securities, as well as any other entities that may be added to the accredited investor definition in the future, provided that any such entities would also have to meet the \$100 million threshold to qualify as QIBs.

The proposal is expected to be published in the Federal Register shortly.

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