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## More investors to be accredited under amended SEC rules

On August 26, the SEC amended its rules under the Securities Act of 1933 to expand the definition of “accredited investor” used for determining eligibility to invest in certain securities offerings exempt from Securities Act registration. The amendments represent some of the most extensive changes to the definition since the SEC adopted the accreditation rule in 1982 as part of Regulation D under the Securities Act.

The amendments add new categories of natural persons and entities to the accredited investor definition and modestly enlarge the scope of some of the existing categories. Notably, the SEC has supplemented the income and net worth tests for accreditation of natural persons with a test for financial sophistication based on a person’s professional certifications, designations, or other credentials, or the person’s status as a “knowledgeable employee” of a private fund. The SEC also has expanded the list of entities that qualify as accredited investors to encompass entities owning in excess of US\$5 million in “investments” and family offices having more than US\$5 million in assets under management and their family clients. In addition, the SEC has expanded the definition of “qualified institutional buyer” in Rule 144A under the Securities Act to line up with the expanded accredited investor categories.

The amendments will become effective 60 days after they are published in the Federal Register.

The amended rules are discussed in the SEC’s adopting release (No. 33-10824), which is available [here](#).

### Significance of accredited investor status

The accredited investor standards are set forth in Securities Act Rule 501(a) for private and limited securities offerings conducted in reliance on Rule 504 or Rule 506 of Regulation D and in Securities Act Rule 215 for exempt offerings made under Section 4(a)(5) of the Securities Act.

Under Rule 504(b)(1), where permitted by applicable state law, limited offerings to accredited investors are exempted from registration and also from the prohibition on general solicitation otherwise applicable under that rule. Sales of securities made solely to accredited investors under Rule 506 are not subject to the information requirements of Rule 502(b), and do not count toward the 35-purchaser limit under Rule 506(b). Private offerings pursuant to Rule 506(c), which allows general solicitation, permit only accredited investors to participate. In addition, an accredited investor in a Rule 506 offering is not subject to the rule’s requirement that the investor, either alone or with a purchaser representative, have financial sophistication sufficient to evaluate the merits and risks of the prospective investment.

In its release adopting the amendments, the SEC states that in 2019 issuers raised an estimated US\$1.56 trillion of new capital in offerings under Rules 506(b) and 506(c).

### Summary of changes to accredited investor definition

The rule changes add new categories to the accredited investor definition and modify some of the existing categories.

#### *New accredited investor categories*

*New accreditation categories for natural persons.* The amendments add two new categories of natural persons who will qualify as accredited investors irrespective of personal wealth or income.

A natural person is accredited under the current rules if the individual has either (1) a net worth (or joint net worth with a spouse) in excess of US\$1 million, excluding the value of a primary residence (Rule 501(a)(5)), or (2) an annual income in excess of US\$200,000 in each of the two most recent years (or a joint annual income



of US\$300,000 with a spouse), with the reasonable expectation of reaching the same income level in the current year (Rule 501(a)(6)). In adding the new accreditation tests, the SEC indicates that “relying solely on financial thresholds as an indication of financial sophistication is suboptimal” because it may unduly restrict access to investment opportunities for individuals whose knowledge and experience render them capable of fending for themselves in private offerings.

Under the new rules, natural persons may qualify for accreditation if they fall within either of the following categories:

- *Natural persons holding professional certifications, designations, or other credentials.* The first category, added in a new paragraph (10) to Rule 501(a), permits a natural person to qualify as an accredited investor based on holding in good standing one or more professional certifications, designations, or credentials which the SEC may designate by order from time to time (and will post on the SEC’s website), and that demonstrate knowledge and experience in the areas of securities and investing. In making such a designation, the SEC will consider all of the pertinent facts, including in particular a non-exclusive list of attributes with respect to the applicable certification, designation, or credential, such as whether it 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.

In connection with its adoption of the amendments, the SEC initially has designated holders in good standing of the following certifications or designations issued by the Financial Industry Regulatory Authority (FINRA) upon successful completion of qualification examinations identified by series number:

- licensed general securities representatives (Series 7);
- licensed investment adviser representatives (Series 65); and
- licensed private securities offering representatives (Series 82).

The SEC considered comments on the rule proposal advocating accreditation of holders of a variety of other professional designations, such as certified public accountant (CPA), chartered financial analyst

(CFA), and certified financial planner (CFP), as well as certain educational degrees, such as legal or business administration degrees, but concluded that these designations and degrees do not reliably demonstrate an individual’s comprehension and sophistication in securities and investing, or have other shortcomings. The SEC also decided not to permit a natural person to self-certify that the person possesses the required financial sophistication to be an accredited investor, citing “the lack of standards applicable to such an approach.”

- *Natural persons who are knowledgeable employees.* The second category, added in a new paragraph (11) to Rule 501(a), permits “knowledgeable employees” of a private fund to qualify as accredited investors for purposes of investments in the fund. For purposes of new paragraph (11), private funds, such as hedge funds, venture capital funds, and private equity funds, are those issuers that would be an “investment company,” as defined in Section 3 of the Investment Company Act of 1940, but for the exclusion provided by either Section 3(c)(1) or Section 3(c)(7) of that statute. The amendment defines “knowledgeable employee” by reference to Rule 3c-5(a)(4) under the Investment Company Act. That definition includes, among other persons:
  - executive officers, directors, trustees, general partners, advisory board members, or persons serving in a similar capacity of a private fund, or an affiliated person of the fund that oversees the fund’s investments; and
  - employees or affiliated management persons of the fund who, in connection with such persons’ regular functions or duties, have participated in the investment activities of the fund (or certain other funds or investment companies) for at least 12 months.

The definition expressly excludes employees performing solely clerical, secretarial, or administrative functions. The SEC notes that this category will be similar to the existing category, contained in Rule 501(a)(4), for directors, executive officers, or general partners of the issuer, and reflects the SEC’s belief that these persons, by reason of their position with the fund, are likely to have meaningful investing experience and sufficient access to the information necessary to make informed investment decisions with respect to the fund.

*New categories of entities.* The rule amendments add the following new categories of entities to the accredited investor definition.

- *Entities owning over US\$5 million of investments:* A new paragraph (9) of Rule 501(a) adds as an accredited investor any entity (not otherwise expressly included in the definition of accredited investor) that is not formed for the specific purpose of acquiring the securities offered and that owns “investments” in excess of US\$5 million. “Investments” for purposes of this catch-all category is defined by reference to Rule 2a51-1(b) under the Investment Company Act. That definition includes, among other items, securities; real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents. The SEC indicates that new Rule 501(a)(9) is intended to extend accredited investor status to certain federal, state, and local governmental entities and American Indian tribes, as well as to entities organized under the laws of foreign countries. The category also will extend accreditation to forms or types of entities that may be created in the future.
- *Family offices and family clients:* A new paragraph (12) of Rule 501(a) adds as an accredited investor any “family office” as defined in Rule 202(a)(1)(G)-1 under the Investment Advisers Act of 1940 which (1) has assets under management in excess of US\$5 million, (2) is not formed for the specific purpose of acquiring the securities offered, and (3) has prospective investments directed by a person with sufficient knowledge and experience in financial and business matters that the family office is capable of evaluating the merits and risks of the prospective investment. Family offices are entities established by families to manage their assets, plan for their families’ financial future, and provide other services to family members. A new paragraph (13) of Rule 501(a) accredits any “family client” (as defined in the same rule under the Investment Advisers Act) of such a family office. Family clients generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities.
- *SEC- and state-registered investment advisers:* Expanded Rule 501(a)(1) adds as an accredited investor any investment adviser registered pursuant

to Section 203 of the Investment Advisers Act or registered pursuant to the laws of a state, and any investment adviser relying on the exemption from registration with the SEC afforded by Section 203(l) or (m) of the Investment Advisers Act.

- *RBICs:* Expanded Rule 501(a)(1) adds as an accredited investor any rural business investment company (RBIC), as defined in Section 384A of the Consolidated Farm and Rural Development Act. RBICs are companies that have entered into a participation agreement with the Secretary of Agriculture and are intended to promote economic development and the creation of wealth and job opportunities in rural areas. The SEC determined that RBICs should be treated in the same manner as small business investment companies, which share the purpose of promoting capital formation and already qualify as accredited investors under Rule 501(a)(1).
- *Limited liability companies:* Codifying a long-standing SEC staff position, amended Rule 501(a)(3) provides that limited liability companies with total assets in excess of US\$5 million are entities that qualify as accredited investors under that paragraph, so long as such entities are not formed for the specific purpose of acquiring the securities offered. Current Rule 501(a)(3) expressly extends accreditation to corporations, Massachusetts or similar business trusts, partnerships, and organizations described in Section 501(c)(3) of the Internal Revenue Code.

#### *Modifications of existing accredited investor categories*

The rule amendments also make the following changes to existing accredited investor categories:

- *Spousal equivalents:* Amended Rules 501(a)(5) and (6) provide that, in calculating net worth and income for purposes of evaluating accredited investor status, an investor may aggregate the investor’s net worth or income with that of the investor’s “spousal equivalent” as well as spouse. A new paragraph (j) of Rule 501(a) defines “spousal equivalent” to mean “a cohabitant occupying a relationship generally equivalent to that of a spouse.”
- *Joint net worth:* A new Note 1 to Rule 501(a)(5) states that, for purposes of calculating an individual’s “joint net worth” with a spouse or spousal equivalent, assets need not be jointly held to be included in the calculation. The Note also clarifies that reliance on

the joint net worth standard of Rule 501(a)(5) does not require that the securities acquired in the offering be purchased jointly.

- *Look-through:* Under Rule 501(a)(8), an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors. A new Note 1 to Rule 501(a)(8) states that, in determining accredited investor status under this paragraph, it is permissible to look through various forms of equity ownership to owners who are natural persons, and that if the natural persons themselves are accredited investors (so long as all other equity owners of the entity seeking accredited investor status are also accredited investors), the entity will be deemed an accredited investor.

### Amendment to Rule 215

Rule 215 defines the term “accredited investor” under Section 2(a)(15) of the Securities Act for purposes of Section 4(a)(5) of the Securities Act, which provides what the SEC notes is an infrequently used alternative to Regulation D to exempt from registration the offer and sale of securities to accredited investors. The accredited investor definition in Rule 215 historically has been substantially consistent with, but not identical to, the definition in Rule 501(a). To ensure uniformity in the definition in both rules, the SEC has replaced the existing definition in Rule 215 with a cross-reference to the accredited investor definition in Rule 501(a).

### Potential rule changes not adopted

After considering comments on the rule proposal, the SEC expressly declined to modify for inflation the existing financial thresholds for accreditation of natural persons, incorporate geographic-based specific financial thresholds, or extend the definition of accredited investor to all investors advised by a registered investment adviser or a registered broker-dealer.

- *Inflation-adjusted financial thresholds:* The SEC concluded that raising financial thresholds for accreditation to account for inflation could have disruptive effects on the Regulation D market, resulting in a higher cost of capital for some companies. The SEC also highlights developments in addition to inflation—such as increased access to issuer information by a wide range of market participants—which it said should be considered in evaluating the effectiveness of the current net worth- and income-based accreditation criteria.

- *Geographic-specific financial thresholds:* The SEC did not adopt geographic-specific financial thresholds for accreditation of natural persons because of the complexities inherent in implementing such a framework. The SEC speculates that the new accreditation standards might help to mitigate the disparate geographic effects of the long-standing net worth and income criteria.
- *Investors advised by sophisticated third parties:* The SEC decided not to approve accreditation of all investors advised by a registered investment adviser or a registered broker-dealer. The SEC was not convinced that such a standard would be effective to identify investors who possess a level of financial sophistication sufficient to participate in investment opportunities not afforded the additional protections of Securities Act registration.

### Changes to “qualified institutional buyer” definition

The SEC has adopted changes to the definition of “qualified institutional investor” in Rule 144A to align it more closely with the revised accredited investor definition.

The definition of “qualified institutional buyer” in Rule 144A(a)(1)(i) is intended to identify investors that, like accredited investors, are sufficiently sophisticated and knowledgeable to fend for themselves in exempt offerings. Rule 144A provides an exemption from the registration requirements of the Securities Act for offers and sales of qualifying securities to qualified institutional buyers, or “QIBs,” by certain persons other than the issuer of the securities. With the exception of registered dealers, a qualified institutional buyer must own in the aggregate and invest on a discretionary basis at least US\$100 million in securities of issuers that are not affiliated with the investor.

The rule amendments expand the definition of “qualified institutional buyer” to include RBICs and limited liability companies if such entities meet the US\$100 million threshold for securities owned and invested. These changes correspond in part to the amendments to Rules 501(a)(1) and 501(a)(3) discussed above. The amendments also add to the list of enumerated qualified institutional buyers any institutional investors included in the accredited investor definition so long as such investors satisfy the US\$100 million threshold. These changes are intended to avoid inconsistencies between the types of entities eligible for qualified institutional buyer status and entities that qualify as accredited

investors. A new note to Rule 144A(a)(1)(i)(J), however, clarifies that an entity seeking qualified institutional buyer status under that paragraph—unlike an accredited investor seeking qualification as an accredited investor—may be formed for the purpose of acquiring the securities being offered.

## Conclusion

As reflected in most of the comment letters described in the adopting release, the expanded scope of the accredited investor definition will be welcomed by many participants in the private capital markets. The SEC does not expect, however, that the rule changes will significantly increase the number of investors eligible to participate in private offerings or the amount of new capital invested by newly eligible investors.

Issuers and financial intermediaries placing exempt offerings will have to take the rule changes into account in updating due diligence procedures and documents they use to verify eligibility of prospective investors as accredited investors or qualified institutional buyers. Market participants that use questionnaires to screen participants in their exempt offerings should revise those questionnaires to reflect the rule amendments. They also should update their forms of subscription agreement and securities purchase agreement, and similar investment contracts, to ensure that representations, warranties, and certifications regarding investor status accurately reflect the new definitions.

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