December 30, 2019

SEC Proposes Updates to Accredited Investor Definition

On December 18, 2019, the SEC voted (3-2) to propose amendments to expand the definition of "accredited investor." The proposed amendments are intended to update and improve the definition to identify more effectively the institutional and individual investors with the knowledge and expertise to participate in the private capital markets. Although the proposed amendments would provide issuers with additional tests for accredited investor status, the extent to which they would result in substantial new sources of capital is unclear.

In addition, the SEC proposed amendments to the definition of "qualified institutional buyer" ("QIB") in Rule 144A that would expand the list of entities that qualify as QIBs. These amendments, if adopted, would increase the number of potential buyers of Rule 144A securities, and thereby should promote capital formation by issuers conducting Rule 144A offerings.

This Alert briefly summarizes key aspects of the SEC's rulemaking proposal. The deadline to submit comments on this rule proposal to the SEC **is no later than 60 days after the proposal's publication in the *Federal Register*.**[1]

I. PROPOSED AMENDMENTS TO ACCREDITED INVESTOR DEFINITION

Background

The "accredited investor" definition plays an important role in the SEC's exempt offering framework. The definition is a central component of several exemptions from registration under Regulation D. The accredited investor concept in Regulation D was designed to identify – with bright-line standards – a category of investors who do not need the protections of registration under the Securities Act. The accredited investor definition uses income and net worth thresholds to identify natural persons as accredited investors. Under Regulation D, some entities – such as banks, savings and loan associations, registered broker-dealers, insurance companies, and investment companies registered under the Investment Company Act of 1940 – qualify as accredited investors based on their status alone. Other entities may qualify as accredited investors based on a combination of their status and the amount of their total assets.

Qualifying as an accredited investor is significant because accredited investors are eligible to participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds.

Proposed New Categories for Natural Persons

The proposed amendments would add two new categories of natural persons to the accredited investor definition: (1) those who hold certain professional certifications and designations or other credentials and (2) those who are "knowledgeable employees" of a private fund and are investing in the private fund.

Professional Certifications and Designations. The proposal would add a category for natural persons to qualify as accredited investors based on certain professional certifications and designations or other credentials issued by an accredited educational institution that the SEC designates from time to time as meeting specified criteria. The SEC expects to designate in an initial order accompanying the final rule holders of Series 7, 65, or 82 licenses as accredited investors, even when they do not meet the income or net worth standards in the accredited investor definition. The SEC

[1] As of the date of this Alert, the proposal had not been published in the *Federal Register*.

believes that these individuals have demonstrated a level of sophistication in the areas of securities and investing such that they do not need the protections of registration under the Securities Act.

Knowledgeable Employees. The proposal also would add a category that would enable "knowledgeable employees" of a private fund to qualify as accredited investors for investments in the fund. The proposed new category would be the same in scope as the definition of "knowledgeable employee" in Rule 3c-5(a)(4) under the 1940 Act.[2] The SEC believes that such employees, through their knowledge and active participation of the investment activities of the private fund, are likely to be financially sophisticated and capable of fending for themselves in evaluating investments in such private funds, and that allowing these employees to invest in the funds for which they work also may help align their interests with those of other investors in the fund.

Proposed New Categories for Entities

The proposed amendments would expand the types of entities that qualify as accredited investors to include:

- limited liability companies that meet conditions currently applicable to corporations;
- registered investment advisers;
- rural business investment companies ("RBICs"); and
- any entity, including an Indian tribe, owning "investments"[3] in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered.

Family Offices and Family Clients. The proposed amendments also would add any family office with at least $5 million in assets under management and its family clients to the definition of accredited investor. Family offices are entities established by wealthy families to manage their wealth, plan for their families' financial future, and provide other services to family members. In 2011, the SEC adopted a rule to exclude single family offices from regulation under the Investment Advisers Act of 1940 under certain conditions. Under that rule, a family office generally is a company that has no clients other than "family clients," who 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.

Under the proposed amendments, a family office, in addition to having at least $5 million in assets under management, would qualify as an accredited investor only if a 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 the family office was not formed for the specific purpose of acquiring the securities offered.

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[2] Rule 3c-5(a)(4) under the 1940 Act defines a "knowledgeable employee" with respect to a private fund as: (i) 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 (ii) 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. The proposed new category for "knowledgeable employees" in the definition of "accredited investor" would overlap with the existing category in Rule 501(a)(4), which encompasses 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.

[3] The proposal would also incorporate the definition of "investments" from Rule 2a51-1(b) under the 1940 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.

Other Changes

Spousal Equivalents. Under the current accredited investor definition, an individual, together with a spouse, may qualify as an accredited investor by either surpassing the $300,000 joint income threshold or the $1 million joint net worth threshold. The proposal would add to the accredited investor definition the term "spousal equivalent," defined to mean a cohabitant occupying a relationship generally equivalent to that of a spouse, so that spousal equivalents may pool finances for the purpose of qualifying as accredited investors under Rule 501(a)(5) and (6).

Joint Net Worth Calculation. The proposal would add a note to Rule 501 to clarify that the calculation of "joint net worth" for purposes of Rule 501(a)(5) can be the aggregate net worth of an investor and his or her spouse (or spousal equivalent if "spousal equivalent" is included in Rule 501(a)(5), as discussed above), and that the securities being purchased by an investor relying on the joint net worth test of Rule 501(a)(5) need not be purchased jointly.

Equity Ownership. Under Rule 501(a)(8), an entity may qualify as an accredited investor if all of the entity's equity owners are accredited investors. Because, in some instances, an equity owner of an entity is another entity and not a natural person, the proposal would add a note to Rule 501(a)(8) that would codify an existing staff interpretation that permits an entity to look through various forms of equity ownership to natural persons. Thus, if those natural persons are themselves accredited investors, and if all other equity owners of the entity are accredited investors, the entity would be an accredited investor under Rule 501(a)(8).

No Proposed Changes to Financial Thresholds

While acknowledging that the financial thresholds included in the accredited investor definition have not been adjusted for inflation since adoption and observing that a significant increase in the number of investors qualifying as accredited investors has resulted therefrom, the SEC did not propose any changes to the definition's financial thresholds. The proposing release did, however, include a request for feedback on possible adjustments to the financial thresholds in the definition. Commissioner Lee, in her statement on the proposal at the Open Meeting, was critical of the decision to keep the financial thresholds unchanged.

Request for Comments on Investors Who Use Advisers

The proposing release requests comments on whether the SEC should consider other changes to the accredited investor definition, including whether an investor that is advised by a registered investment adviser or broker-dealer should be considered an accredited investor:

> *If we were to permit an investor advised by a registered investment adviser or broker-dealer to be deemed an accredited investor, under what circumstances would that registered financial professional be likely to recommend investing in a Regulation D offering? What types of investors would be likely to receive a recommendation from that registered financial professional to invest in a Regulation D offering?*
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> *If an investor is to be considered an accredited investor by virtue of being advised by a registered investment adviser or broker-dealer, should we consider additional investor protections? For example, should such financial professionals have to eliminate any conflicts of interest related to such advice for its advice to render an investor an accredited investor or should such a financial professional have to mitigate such conflicts of interest in a particular way? Should such financial professionals have to conduct any different due diligence before advising the investor on such investments? Should there be limits on the types or amounts of investments that such an investor could make under these circumstances?*

II. PROPOSED AMENDMENTS TO QIB DEFINITION

Rule 144A provides a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for certain private resales of securities to QIBs. Rule 144A(a)(1)(i) specifies the types of entities– insurance companies, registered investment companies, small business investment companies, certain employee benefit plans, certain bank-maintained collective investment trust funds, business development companies, registered investment advisers, 501(c)(3) organizations, corporations, partnerships, and Massachusetts or similar business trusts – that qualify as QIBs to the extent they own or invest on a discretionary basis at least $100 million in securities of unaffiliated issuers.

Under the proposed amendments, limited liability companies and RBICs would be added to the list of entities that are eligible for QIB status if they meet the $100 million threshold. In addition, a "catch-all" category also would be added, which would include all Rule 501(a) institutional accredited investors in the QIB definition, subject to satisfaction of the $100 million threshold. This "catch-all" category would encompass the proposed new category in the accredited investor definition for entities owning investments in excess of $5 million that are not formed for the specific purpose of acquiring the securities being offered under Regulation D, as well as any other entities that may be added to the accredited investor definition in the future, but such entities would also have to meet the $100 million threshold to be QIBs under Rule 144A.

The SEC's proposing release also noted that the proposed amendments to Rule 144A "would encompass bank-maintained collective investment trusts that include as participants individual retirement accounts or H.R. 10 plans that are currently excluded from the qualified institutional buyer definition pursuant to Rule 144A(a)(1)(i)(F), so long as the collective investment trust satisfies the $100 million threshold." As a result, collective investment trusts that include individual retirement accounts or H.R. 10 plans as participants would qualify as QIBs and would not be precluded from investing in Rule 144A securities.

III. OBSERVATIONS; MORE POSSIBLY TO COME

The proposed amendments, if adopted, should expand the categories of accredited investors allowed to participate in investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds. The proposal addresses some anomalies under the current definitions, particularly related to entities. The SEC acknowledged, however, a lack of data to forecast whether the expanded definitions would increase the sources of capital available for private investments.

Importantly, the SEC's rulemaking proposal represents "an initial step" in the SEC's broader effort to consider ways to harmonize and improve the exempt offering framework. In his remarks at the Open Meeting, Chairman Clayton stated that he "expect[s] more to come in this space in the coming months, including examining whether appropriately structured funds can facilitate greater Main Street investor access to private investments, particularly as a component of an investment portfolio that is analogous to the portfolio of a well-managed pension fund."

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.