September 2, 2020

SEC Modernizes the Accredited Investor Definition

On August 26, 2020, the SEC adopted amendments to expand the definition of "accredited investor." The amendments will allow individual investors to qualify as accredited investors based on defined measures of professional knowledge, experience or certifications, rather than solely based on net worth or income. The amendments also expand the list of entities that may qualify as accredited investors. The amendments, which will become effective 60 days after publication in the *Federal Register*,[1] represent a modest expansion of the definition, designed to expand access to private capital markets to institutional and individual investors with presumptively sufficient knowledge and expertise.

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

This Alert briefly summarizes key aspects of the SEC's final rule amendments.

I. AMENDMENTS TO ACCREDITED INVESTOR DEFINITION

Background

The "accredited investor" definition plays an important role in the SEC's framework for exempt offerings. The definition is a central component of several Regulation D exemptions from registration. 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 of 1933 (the "1933 Act"). The current 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 (the "1940 Act") – 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 many investments in private companies and offerings by certain hedge funds, private equity funds, venture capital funds and other private funds.

New Categories for Natural Persons

The amendments were adopted substantially in the form proposed in December 2019. They add two new categories of natural persons to the accredited investor definition: (1) those who hold certain professional certifications, 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 amendments revise Rule 501(a) to add a category for natural persons holding in good standing certain professional certifications, designations or other credentials issued by an accredited educational institution that the SEC designates from time to time as meeting specified criteria. The SEC believes that certain professional certifications, designations or other credentials provide a reliable indication that an investor has a sufficient level of financial sophistication to participate in unregistered investment opportunities. In connection with the adoption of the amendments, the SEC designated by order holders of Series 7, 65 and 82 licenses as qualifying natural persons.[2] Interested stakeholders may wish to propose to the SEC additional certifications, designations or credentials that satisfy the specified criteria in the final rules.

Knowledgeable Employees. In addition, the amendments add a category that will enable "knowledgeable employees" of a private fund to invest in the fund. The new category matches the definition of "knowledgeable employee" in

Rule 3c-5(a)(4) under the 1940 Act, which allows knowledgeable employees to invest in private funds notwithstanding the requirements of Sections 3(c)(1) or 3(c)(7).[3] A case-by-case assessment is required to determine whether any particular employee is one who participates in the investment activities of a fund or otherwise falls within the "knowledgeable employee" definition with respect to a private fund. The SEC believes that knowledgeable employees are likely to be financially sophisticated and capable of fending for themselves in evaluating investments in a private fund, and that allowing these employees to invest in the funds for which they qualify as knowledgeable employees also may help align their interests with those of other investors in the fund. This change eliminates a discrepancy between the 1933 Act and the 1940 Act as to whether these employees are permitted to invest in private funds.

New Categories for Entities

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

- limited liability companies that meet conditions currently applicable to corporations, which codifies a longstanding staff position;
- all SEC- and state-registered investment advisers;
- exempt reporting advisers;
- rural business investment companies ("RBICs");
- any entity, including an Indian tribe, owning "investments"[4] in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered; and
- family offices with at least $5 million in assets under management and their family clients.

Exempt Reporting Advisers. In a change from the proposal, the SEC included exempt reporting advisers in the accredited investor definition.[5] The SEC believes that exempt reporting advisers, as advisers to private funds, have the requisite financial sophistication to conduct meaningful investment analysis. To qualify as an exempt reporting adviser under Section 203(l) or Section 203(m) of the Advisers Act, an adviser would otherwise be required to register as an investment adviser with the SEC and thereby meet the minimum assets under management thresholds triggering such requirement.[6]

"Catch-All" Category for Entities Meeting an Investments-Owned Test. The SEC clarified that the intent of this new category is to capture all entity types not already included in the accredited investor definition as well as those entity types that may be created in the future. The SEC believes the term "entity" is sufficiently broad to encompass Indian tribes and the divisions and instrumentalities thereof; federal, state, territorial and local government bodies; state and local governmental funds; and entities organized or incorporated under the laws of foreign countries.

Family Offices and Family Clients. The amendments revise Rule 501(a) to add any family office with at least $5 million in assets under management and its family clients. Family offices are entities established by wealthy families to manage their net worth, 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 Advisers Act 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 amendments, a family office, in addition to having at least $5 million in assets under management, will qualify as an accredited investor only if a prospective investment is directed by a person who has such knowledge and

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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.

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 amendments 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 amendments revise Rule 501(a) to add a note that clarifies 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, 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 amendments revise Rule 501(a)(8) to add a note that codifies 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 Changes to Financial Thresholds

The angel investor ecosystem gave a collective sigh of relief when the SEC declined to adopt any changes to the definition's financial thresholds for individual investors, indicating that the comments received on adjustments to the financial thresholds were mixed. The SEC concluded that it is not necessary or appropriate to modify the definition's financial thresholds at this time. Commissioners Lee and Crenshaw, who dissented from adoption of the amendments were critical of the SEC's failure to index the thresholds to inflation going forward.

Investors Who Use Advisers

The SEC also declined to expand the accredited investor definition to include customers of a broker-dealer or clients of a registered investment adviser. The SEC believes that neither a recommendation by a broker-dealer nor advice by a registered investment adviser should serve as a proxy for an individual's financial sophistication or the individual's ability to sustain the risk of loss of investment or ability to fend for him or herself.

Test-the-Waters

When the SEC adopted Rule 163B under the 1933 Act in September 2019 (as described in this Ropes & Gray Alert) to allow all issuers to engage in "test-the-waters" communications with potential investors that are QIBs or institutions that are accredited investors, it made reference to specific parts of the definition in Rule 501(a). Accordingly, it had to revise Rule 163B to refer to the newly added Rules 501(a)(9), (a)(12) and (a)(13) in the list of institutions that are accredited investors, including family offices and family clients that are institutions.

II. AMENDMENTS TO QIB DEFINITION

Rule 144A provides a non-exclusive safe harbor from registration under the 1933 Act for certain private resales of securities to QIBs. Rule 144A(a)(1)(i) specifies the types of entities – currently 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.

The amendments expand the QIB definition to include limited liability companies and RBICs if such entities meet the $100 million threshold. In addition, the amendments also add a "catch-all" category, which will include all Rule 501(a) institutional accredited investors in the QIB definition, subject to satisfaction of the $100 million threshold. This "catch-all" category will encompass the 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, although such entities also will have to meet the $100 million threshold to be QIBs under Rule 144A.

The adopting release noted that the scope of the Rule 144A amendments encompasses bank-maintained collective investment trusts that include as participants individual retirement accounts or H.R. 10 plans that are currently excluded from the QIB definition pursuant to Rule 144A(a)(1)(i)(F), so long as the collective investment trust satisfies the $100 million threshold. Explicit authorization for such collective investment trusts to invest in Rule 144A offerings will resolve an issue that has caused considerable consternation for many years.

III. OBSERVATIONS; MORE TO COME

The amendments represent a modest, incremental expansion of the accredited investor definition. In his statement about the new rule, Chairman Clayton acknowledged that "the change in the definition will provide clearly sophisticated individual investors with more opportunities to invest and to diversify their investment portfolios, but it will not substantially affect aggregate capital flows among participants in private and public markets." In contrast, Commissioners Lee and Crenshaw criticized the final rule for weakening investor protection – in particular, for seniors – in the private markets and for failing to index the definition's wealth thresholds to inflation.

Issuers and other private market participants should review offering documentation, including forms of subscription agreements and questionnaires, to consider updates to reflect the amendments.

Importantly, the amendments are part of the SEC's broader effort to simplify, harmonize and improve the exempt offering framework under the 1933 Act to promote capital formation and expand investment opportunities while maintaining and enhancing appropriate investor protections.

- In June 2019, the SEC published its *Concept Release on Harmonization of Securities Offering Exemptions* to solicit public comment on exemptions from registration under the 1933 Act (described in this Ropes & Gray Alert).

- The June 2019 concept release noted that, over time, there had been significant changes to the framework for exempt offerings, resulting in gaps and complexities. Therefore, the concept release stated, the SEC solicited comments on ways "to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections." The adopting release is arguably the SEC's most concrete step to date to give effect to SEC Chairman Clayton's stated goal of broadening "main street" access to investments in private companies.

The adopting release notes that the amendments "will provide a foundation for the [SEC's] ongoing efforts to assess whether the exempt offering framework . . . is consistent, accessible and effective for both issuers and investors."

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

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1. As of the date of this Alert, the final rule had not been published in the *Federal Register*.
2. The SEC's order will become effective 60 days after publication in the *Federal Register*. As of the date of this Alert, the order had not been published.
3. 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 new category for "knowledgeable employees" in the definition of "accredited investor" overlaps 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.
4. The amendments 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, non-security financial contracts held for investment purposes and cash and cash-equivalents.
5. An exempt reporting adviser is an investment adviser that qualifies for the exemption from registration under Section 203(l) of the Investment Advisers Act of 1940 (the "Advisers Act") because it is an adviser solely to one or more venture capital funds, or under Rule 203(m)-1 of the Advisers Act because it is an adviser solely to private funds and has assets under management in the United States of less than $150 million.
6. Absent an applicable exemption, advisers must register with the SEC if their regulatory assets under management are at least $110 million or if they have regulatory assets under management of at least $25 million but less than $100 million and meet one of the requirements to be classified as a "mid-sized adviser."

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