SEC proposes changes to "accredited investor" definition

Financial Services Alert

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The SEC recently proposed amendments to the long-standing definition of "accredited investor," an important qualification standard under the securities laws that determines what types of investors may invest in certain kinds of private securities offerings, including securities offerings conducted pursuant to Rules 506(b) and 506(c) of Regulation D under the Securities Act of 1933 and other important federal and state securities law exemptions.

The current definition of "accredited investor" has been in place without any significant update since 1985. At a high level, the proposal would expand the number of natural person investors that qualify by adding categories of eligibility based on their professional knowledge, experience or certifications. The proposal would also expand the types of entities that qualify as "accredited investors." The proposed changes would allow additional persons and entities to qualify as "accredited investors," thereby allowing them to purchase securities through private offerings, including shares and interests in certain private investments funds.

Notable changes

The proposal includes the following notable changes:

- ***Professional designations***. The proposal would allow natural person investors to qualify solely on the basis of holding certain professional certifications and licenses which the SEC designates as qualifying the investor. The SEC set forth in the proposed rule some non-exclusive attributes it would consider in making such designations, which may change over time due to changing circumstances. The SEC currently anticipates that natural persons holding a Series 7, 65 or 82 license would qualify and is considering whether any other credentials issued by accredited educational institutions should be included. Ultimately, the professional certifications and designations determined to qualify a natural person would be posted on the SEC's website. For issuers engaged in Rule 506(c) offerings under Regulation D (*ie*, general solicitation offerings) which require reasonable steps to verify each investor's accredited investor status, having categories of eligibility that are based on publicly available information such as one's status as a holder of a Series 7 (General Securities Representative) license verifiable on FINRA's BrokerCheck could be helpful in discharging their verification obligation.
- ***Knowledgeable employees***. With respect to an investment in a private fund, the proposal adds a new category of accredited investor for individuals who qualify as "knowledgeable employees" of the fund as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940. Under the Investment Company Act, knowledgeable employees are permitted to invest in private funds without affecting the fund's eligibility for the exclusions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Knowledgeable employees of a private fund generally include executive officers, directors, trustees, general partners or persons serving in a similar capacity with respect to the fund or its

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manager and employees of the private fund or its manager (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions, have participated in the investment activities of such private fund or other funds managed by the same or an affiliated manager for at least 12 months.

- ***Spousal equivalent***. Under the current rule, a natural person, together with a spouse, may qualify as an accredited investor by either having at least $300,000 in joint income in the two most recent years or at least $1 million in joint net worth. The proposed amendment would broaden both the income and net worth criteria to include "spousal equivalents" (*ie*, a cohabitant occupying a relationship generally equivalent to that of a spouse) so that the income and net worth of spousal equivalents would count toward these tests even if the securities were purchased individually and not jointly.
- ***Entities by type***. The proposal also would broaden the types of entities that qualify as accredited investors to include by definition entities (regardless of whether they satisfy the $5 million total asset threshold for entities generally) that are (i) registered with the SEC or a state securities authority as an investment adviser or (ii) rural business investment companies (RBICs). In addition, the proposal includes amendments to codify the longstanding position of the SEC staff that limited liability companies that have not been formed for the purpose of making the investment and that have total assets in excess of $5 million qualify as an accredited investor (despite not currently being listed in the text of the rule).
- ***Catch-all for entities with at least $5 million in investments***. The proposal would add a new category of accredited investor to capture any type of entity owning "investments" in excess of $5 million and that is not formed for the specific purpose of investing in the securities offered. The SEC is proposing this new catch-all category to cover existing types of entities not specifically enumerated in the definition such as Indian tribes, labor unions, governmental bodies and funds, and foreign entities, as well as entity forms that may be created in the future. For this purpose, "investments" would be defined by reference to Rule 2a51-1(b) under the Investment Company Act, which is commonly used to determine an investor's status as a "qualified purchaser."
- ***All equity owners look-through***. Under the existing rule, an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors. The proposed amendment adds a note consistent with an existing SEC staff interpretation to clarify that it is permissible to look through multiple layers of equity ownership of an entity to natural persons to determine whether all of the equity owners of that entity are accredited investors.
- ***Family offices***. The proposal would add new categories of accredited investors for (i) "family offices" as defined in Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (a) with at least $5 million in assets under management, (b) that are not formed for the specific purpose of acquiring the securities offered and (c) whose 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 (ii) "family clients," as defined in Rule 202(a)(11)(G)-1, of a family office meeting the criteria specified above. In making this proposal, the SEC cites the same public policy argument that led to the adoption of the family office rule excluding certain family offices from the definition of investment adviser.
- ***QIBs***. The proposal would also expand the qualified institutional buyer exemption under Rule 144A by adding RBICs to Rule 144A(a)(1)(i)(C) and limited liability companies to Rule 144(a)(1)(i)(H). Moreover, the proposal would add a new provision to ensure that entities that qualify for accredited investor status also qualify for qualified institutional buyer status when they meet the $100 million in securities owned and invested threshold in Rule 144(a)(1)(i).

Next steps

The proposal is subject to a 60-day comment period from the date of publication in the Federal Register. Given the widespread use of Regulation D for private securities offerings by many different types of issuers (including by most private funds offered to US investors), the proposal would significantly impact many private securities offerings conducted in the US. Please contact one of the authors or your usual contact at DLA Piper if you have any questions.

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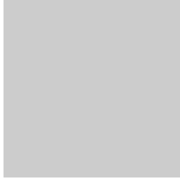

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