



SEC adopts changes to "accredited investor" definition

Corporate Alert

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The SEC recently adopted 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 to natural persons and entities conducted pursuant to Rules 506(b) and 506(c) of Regulation D under the Securities Act of 1933 and "qualified institutional buyers" for Rule 144A under the Securities Act and other important federal and state securities law exemptions. The final rule adopted by the SEC is substantially similar to the proposed rule with a few teaks based on comments it received as part of the adoption process.

The current definition of "accredited investor" has been in place without any significant update since 1985. At a high level, the rule broadens the categories of individuals and entities that qualify by adding categories of eligibility based on their professional knowledge, experience or certifications and allows these investors to further qualify as "accredited investors" thereby making them eligible to participate in private capital markets. The stated purpose of the amendments is to "update and improve the definition to more effectively identify institutional and individual investors that have the knowledge and expertise to participate in those markets." Ultimately, the amendments allow individuals and entities to participate in private capital markets not only based on their income or net worth, but also based on established, clear measures of

financial sophistication.

While some experts argue that the new rule doesn't alter much as existing case law and interpretation arguably allowed for financial sophistication, the amendments allow for well-defined measures of professional knowledge, experience or certification in addition to the long-standing tests for income or net worth. The amendments also expand the types of entities that qualify as "accredited investors," including by allowing any entity that meets an investments test to qualify. This expansion closes gaps in the definition that historically have either prevented otherwise qualified institutional investors from participating in private placements under Regulation D, or required the issuer to prepare an additional disclosure document to admit up to 35 non-accredited investors under Rule 506(b) (note that this option is not available for issuers relying on general solicitation under Rule 506(c)).

Notable changes

The new rule includes the following notable changes:

New categories of natural persons

- **Professional designations.** The amendments 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 rule some non-exclusive attributes it would consider in making such designations, which may change over time due to changing circumstances. In a concurrent order, the SEC designated natural persons holding a Series 7 (licensed general securities representative), Series 65 (licensed investment adviser representative), or Series 82 (licensed private securities offerings representative) license as qualifying. The SEC also laid out additional qualifying credentials that will be used to evaluate future designations. Ultimately, the professional certifications and designations determined to qualify a natural person would be posted on the SEC's website. The final rule does not permit individuals to self-certify that they have the requisite financial sophistication to be an accredited investor.

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 license verifiable on FINRA's BrokerCheck could be helpful in discharging their verification obligation. Moreover, this will allow the SEC some flexibility to alter or make additional designations over time.

- **Knowledgeable employees.** With respect to an investment in a private fund, the new rule 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 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 adopted 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 amendments 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.

Broadening of qualified entities

- **Entities by type.** The amendments also 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 (i) are registered with the SEC or a state securities authority as an investment adviser, or that file reports with the SEC as an exempt reporting adviser (eg, a mid-sized private fund adviser or an adviser solely to venture capital funds) or (ii) are rural business investment companies (RBICs). In addition, the new rule 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.

- **Catchall for entities with at least \$5 million in investments.** The amendments also 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. This new catch-all category covers 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” are defined by reference to Rule 2a51-1(b) under the Investment Company Act, which is 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. This particular 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 new rule adds 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 adopting the amendments, 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 amendment also expands 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 amendments 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).

The final amendments did not distinguish these entity categories to any particular organizational form, as organizational form is irrelevant for the purpose of these broadened entity categories.

Practical considerations

The amendments will become effective 60 days following formal publication in the Federal Register, which means the rules will start to apply to new offerings in early November. Taking into consideration the vast use of Regulation D and Rule 144A offerings by various types of issuers (including by most private funds offered to US investors), the amendments significantly impact many private securities offerings conducted in the US. DLA Piper has updated its accredited investor and/or QIB questionnaires based on these new accredited investor parameters. If you need a new questionnaire or would like further information about the amendments, please contact one of the authors or your usual DLA Piper attorney.

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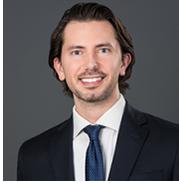


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