SEC Adopts Expanded Definition of Accredited Investor Providing Investors More Access to Private Markets

September 3, 2020

On August 26, 2020, the Securities and Exchange Commission (the "SEC") adopted, largely as proposed, its final amendments (the "Final Amendments") to the definition of "accredited investor" under the Securities Act of 1933 (the "Securities Act").[1] The Adopting Release principally focused on responding to commenters on the 2019 Proposal and highlighting the few modifications made in response.

As part of a larger effort to simplify, harmonize and improve the exempt offering framework under the Securities Act, the Final Amendments are intended to promote capital formation, expand investment opportunities and make exempt offering frameworks more consistent, accessible and effective for both issuers and investors. While the SEC did not explicitly cite expanding exempt offerings to retail investors as central to adopting the Final Amendments, the Final Amendments, consistent with the 2019 Proposal, provide additional bases for natural persons to be accredited investors that complement the asset, net worth and income thresholds that historically served as a proxy for a natural person's ability to participate in exempt offerings. While these changes likely will not provide private fund sponsors with significant new sources of capital, the Final Amendments should increase opportunities for employees of private fund sponsors to invest in the sponsor's private funds and provide family offices with greater flexibility in structuring their investments in private funds and other private issuers. As such, private fund sponsors may wish to review and update their subscription agreements and other documentation to reflect the Final Amendments.

Summary of Final Amendments

The Final Amendments expand the definition of an "accredited investor" by adding the following new categories:

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[1] Amending the "Accredited Investor" Definition, Release Nos. 33-10824; 34-89669; File No. S7-25-19 (Aug. 26, 2020), *available* here (referred to herein as the "Adopting Release"). The amendments were proposed last year. *See* Amending the "Accredited Investor" Definition, SEC Release Nos. 33-10734; 34-87784 (Dec. 18, 2019) (the "2019 Proposal"). For more information on the 2019 Proposal, please refer to our client update, *available* here.

- *Natural Persons with Certain Professional Certifications*. Natural persons holding, in good standing, one or more of the following professional certifications or designations: the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative (Series 65) certification; the SEC may in the future designate additional certifications and credentials as qualifying for accredited investor status.[2]

- *Knowledgeable Employees*. With respect to private fund offerings, natural persons who are "knowledgeable employees" as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940 (the "Investment Company Act") of the private fund issuing the securities being offered or sold. This is a broad category that includes not only persons employed by the private fund offering the securities in question, but senior and executive officers of the private fund's manager and certain persons who participate in the investment activities of the manager's private funds.

- *Family Offices*. "Family offices" as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (the "Advisers Act") with assets in excess of $5 million that are not formed for the specific purpose of acquiring the securities offered and whose prospective investment is directed by a person with sufficient knowledge and experience in financial and business matters ("Eligible Family Offices").

- *Family Clients*. "Family clients" as defined in rule 202(a)(11)(G)-1 under the Advisers Act of an Eligible Family Office, whose prospective investment in the issuer is directed by such Eligible Family Office.

- *Exempt and Registered Investment Advisers*. SEC- and state-registered investment advisers and any investment adviser relying on the exemption from registration available to certain private fund and venture capital fund advisers under section 203(l) or (m) of the Advisers Act (an "ERA").

- *Other Entities*. Rural business investment companies, limited liability companies and any entities not listed in section 501(a)(1), (a)(2), (a)(3), (a)(7) or (a)(8) of the Securities Act (e.g., an Indian tribe or sovereign wealth fund) that are not formed for the specific purpose of acquiring the securities offered and own investments in excess of $5 million.

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[2] Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status Pursuant to Rule 501(a)(10) under the Securities Act of 1933, Release No. 33-10823 (Aug 26, 2020), *available* here (referred to herein as the "Order").

The inclusion of an ERA as an "accredited investor" is the only material change from the 2019 Proposal.

Consistent with the 2019 Proposal, the SEC did not update the current accredited investor net worth or income aggregate dollar standards, but did add a "spousal equivalent" to the accredited investor definition so that spousal equivalents (and not just "spouses") may pool their finances for the purpose of qualifying as accredited investors. The SEC also adopted conforming amendments to rule 163B under the Securities Act and to rule 15g-1 under the Securities and Exchange Act of 1934. The Final Rule takes effect 60 days after publication in the Federal Register. The Final Rule has not been published in the Federal Register as of this publication.

For reference, a redline showing the final changes to section 501 of the Securities Act is available here.

The SEC's Response to Industry Comments

Natural Persons with Certain Professional Certifications

The Adopting Release notes that many commenters supported the addition of some form of professional certifications, designations or other credentials and requested that they be expanded to include all FINRA exams, professional credentials (such as certified public accountants and chartered financial analysts, among others), educational attributes (such as law degrees and MBAs, among other graduate degrees), and professional experience in areas such as finance and investing. While the SEC adopted the Final Amendments substantially as proposed, the Final Amendments include a nonexclusive list of attributes that the SEC will consider in determining further designations. These attributes include:

- the certification, designation or credential 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;

- the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;

- persons obtaining such certification, designation or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and

- an indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

The SEC did not wish to expand any such qualifying credentials beyond those originally proposed until it has the chance to assess the impact of the Final Amendments. The SEC encourages persons who believe that a specific degree, program of study or credential fulfills the nonexclusive list of attributes to submit proposals to the SEC for consideration. It will likely be important for these proposals to focus on how possession of these credentials can be verified.

Knowledgeable Employees

The Adopting Release notes that commenters generally supported including "knowledgeable employees" as a new category and requested its expansion for purposes of determining accredited investors. Commenters suggested, for example, including (i) a broader pool of employees such as analysts and contract administrators, (ii) individuals investing in the general partner or similar entities of a private fund and (iii) individuals investing in privately offered pooled investment vehicles that are not private funds, among others.

The Final Amendments do not modify the definition as requested but appear to emphasize that the "knowledgeable employee" category is broader than suggested by the commenters. *First*, the Adopting Release highlights that many employees of managing entities are likely already included through the concept of "affiliated management persons" (as defined in Rule 3c-5 under the Investment Company Act) and through existing language of the Investment Company Act that includes persons who, in connection with their regular functions and duties, participate in the investment activities of the fund or of other entities managed by affiliated management persons of the fund. *Second*, the SEC emphasized that the new knowledgeable employee category under section 501 of the Securities Act is not intended to limit accredited investor status to only those knowledgeable employees making investments in the private fund of which they participate in management. *Finally*, the SEC stressed that the scope as adopted accurately captures nonexecutive employees with sufficient knowledge and expertise to participate in investment opportunities and that it would be inconsistent with current SEC efforts to create a definition that is different from the one in the Investment Company Act.

The 2019 Proposal requested comments on whether a knowledgeable employee's accredited investor status should be attributed to his or her spouse or dependents when making joint investments in private funds, which was generally supported. The Final

Amendments adopt this attribution but only with respect to spouses when making joint investments.

Other Notable Commentary and Changes

Catchall Category for Entities

Consistent with the 2019 Proposal, the Final Amendments include a catchall category for any entity that is not formed for the specific purpose of acquiring the securities offered and owns investments in excess of $5 million. The SEC made clear that this is intended to be sufficiently broad in context to encompass Native American tribes and instrumentalities thereof, federal, state, territorial and local government bodies, and entities organized or under the laws of foreign countries.

Qualified Purchasers

While commenters requested including "qualified purchasers" as defined in section 2(a)(51)(A) of the Investment Company Act, the SEC did not adopt this change on the basis that most qualified purchasers already meet the definition of accredited investor by virtue of the higher financial thresholds and, while there may be limited circumstances where this is not the case, the SEC does not believe that it would be appropriate to extend the accredited investor definition in such a manner, given that these are two different standards that serve different regulatory purposes.

Family Offices and Family Clients

The Final Amendments include the categories substantially as proposed in the 2019 Proposal. Of note, for "family clients" to qualify as accredited investors, they must be clients of an Eligible Family Office.

Adjustments to Income Thresholds and Calculation of Net Worth

The 2019 Proposal sought comments on whether updates were necessary to financial thresholds and whether certain assets or liabilities should be excluded in the calculation of net worth. In this respect, the SEC noted that comments were mixed and, after considering these comments, continues to believe that it is not necessary or appropriate to modify the financial thresholds or calculation of net worth at this time.

Qualified Institutional Buyer

The Final Amendments expand the list of entities eligible for qualified institutional buyer status to be consistent with amendments to the accredited investor definition, maintaining the $100 million threshold. With this final expansion, the SEC seeks to expand the types of entities with whom an issuer may engage in test-the-waters communications. The SEC, however, declined to include as a qualified institutional buyer a private fund with $100 million in gross asset value and its investment adviser, noting their belief that adding a new financial threshold would be inappropriate and could lead to confusion, and that most private funds with $100 million in gross asset

value will already meet existing definitions of "qualified institutional buyer." As such, this continues to be an issue for many private equity funds that have a substantial amount of securities in affiliated issues and for new private equity funds with little or no assets.

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Please do not hesitate to contact us with any questions.

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