SUMMER'S OVER, BUT THE POOL IS OPEN: SEC EXPANDS THE DEFINITION OF ACCREDITED INVESTOR

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U.S. Asset Management and Investment Funds Alert

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INTRODUCTION

On 26 August 2020, the U.S. Securities and Exchange Commission (the SEC) adopted amendments to Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended (the Securities Act), which expand the definition of "accredited investor" (the Final Rule).[1] The Final Rule substantially adopts amendments that were initially proposed on 18 December 2019 (the Proposed Rule)[2] and will expand the pool of accredited investors eligible to participate in certain exempted offerings by, among other things, formally including knowledgeable employees as accredited investors; broadening the accredited investor definition with respect to certain entities, such as family offices and limited liability companies (LLCs); and extending the definition of accredited investor to include certain persons holding "in good standing" certain securities licenses typically associated with the personnel of broker-dealers and/or registered investment advisers.[3]

The Final Rule is also notable for what it does not amend. In particular, the SEC declined to raise the standards for accreditation for individuals through income (US$200,000 for an individual, US$300,000 for a married couple) or net worth (US$1,000,000), which were established in 1982 and which some have argued have been eroded by inflation.[4] The Final Rule also does not extend accredited investor status to all investors who purchase securities on the advice of third-party investment advisers or other third-party financial professionals (although certain "family clients" advised by "family offices" are deemed accredited investors under the Final Rule).

Undergirding the Final Rule is the SEC's current belief that private offerings play a significant role in capital formation in the United States and that more (but not too many more) investors should have access to them. This somewhat moderate view is still a beneficial one for the investment management industry and, in particular, for the managers of private funds,[5] specifically those that are exempt from registration in reliance on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the 1940 Act) (although the investor limits for such funds will continue to apply). Because the SEC has not adopted changes to the definition of "qualified purchaser" under the 1940 Act, investors in private funds that rely on the exemption in Section 3(c)(7) of the 1940 Act will continue to need to meet that higher standard in addition to the accredited investor standard.

The Final Rule will become effective 60 days after publication in the *Federal Register*.

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FINAL RULE

Background

In 1982, the SEC adopted a series of rules, collectively designated "Regulation D," which provide certain issuers with safe harbors from the registration and prospectus delivery requirements of the Securities Act. Rule 506 of Regulation D provides a nonexclusive safe harbor, whereby an issuer that meets the requirements of the rule is deemed to have made an offering exempt from registration under Section 4(a)(2) of the Securities Act. Although other exemptions are available under the federal securities laws, Regulation D has become the predominant safe harbor relied upon by issuers in private offerings, including private fund sponsors.[6]

In a securities offering under Rule 506(b), an issuer generally may sell an unlimited amount of securities to: (i) up to 35 nonaccredited investors, and (ii) an unlimited number[7] of "accredited investors."[8] At the time of the Proposed Rule's publication, a purchaser would be an accredited investor if at the time of the sale of a security the purchaser met, or the issuer "reasonably believed" that the purchaser met, one of eight specific categories set forth in Rule 501(a).[9] As a general matter, these categories are intended to provide objective standards of sophistication sufficient for participation in unregistered offerings, which do not offer investors certain protections the SEC believes registered offerings do.

The Final Rule is the result of years of efforts by the SEC and its staff to consider and analyze possible approaches to revising the accredited investor definition, precipitated largely by the Dodd-Frank Act's commandment that the SEC review the accredited investor definition at least every four years.[10]

The SEC received more than 200 comments on the Proposed Rule, with many commenters supporting the expansion of the accredited investor definition. As a result, the SEC adopted the amendments to the accredited investor definition substantially as proposed, with the exception of certain modifications noted below.

Entities Qualifying as Accredited Investors

Additional Qualifying Entities. The Final Rule expands the types of entities that qualify as accredited investors under Rule 501(a), adds a "catch-all" category for entities with US$5 million in "investments," clarifies the current ownership look-through provision, and permits certain family offices to qualify, as described below.

- *Family Offices and Certain Family Clients.* The Final Rule allows "family offices" with at least US$5 million in assets under management and, to the extent such family offices direct the relevant investments, their "family clients" (as each term is defined in Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940, as amended (the Advisers Act)) to qualify as accredited investors. The SEC incorporated family offices and family clients into the accredited investor definition on the belief that "family offices and their family clients can sustain the risk of loss of investment, given their assets" and that "certain protections otherwise afforded to less financially sophisticated investors by federal securities laws" are not needed to protect such family offices and their family clients.[11]
- *Registered Investment Advisers and Exempt Reporting Advisers.* Investment advisers that are registered under Section 203 of the Advisers Act or under state law are accredited investors under the Final Rule. In a departure from the Proposed Rule, and in response to comments received by the SEC, exempt reporting advisers (i.e., advisers that qualify for the exemption from registration under the Advisers Act under Section 203(l) or under Rule 203(m)-1) will also be deemed accredited investors. Importantly, this

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new category applies only where the investment adviser itself is the investor of record; as discussed in Section III, clients of an investment adviser, including an exempt reporting adviser's private fund clients (except with respect to clients of certain family offices, as discussed above), shall not be considered accredited investors merely because they are advised by an investment adviser.

- *All Entities with More than US$5 Million in Investments.* The Final Rule adopts a "catch-all" category of accredited investors set forth in the Proposed Rule: entities with more than US$5 million in "investments," as defined in Rule 2a51-1(b) under the 1940 Act, not formed for the specific purpose of acquiring the offered securities. This catch-all provision was primarily adopted to encompass entity types that have not historically been explicitly contemplated by the accredited investor definition, such as American Indian tribes, labor unions, governmental bodies, and funds and entities organized under the laws of a foreign country. Additionally, and likely more practically important in the long term, the catch-all is intended to capture entity types not yet in existence that meet the investments test. Finally, the catch-all provides an alternate basis for accreditation for entity types already contemplated by the accredited investor definition.[12]
- *LLCs.* Codifying the long-standing position of the SEC staff, LLCs with total assets in excess of US$5 million are accredited investors under the Final Rule.
- *Ownership Look-Through.* Existing Rule 501(a)(8) permits an entity to qualify as an accredited investor if all of the entity's equity owners are accredited investors. The Final Rule adds a clarifying note to Rule 501(a)(8) that an issuer may look through the various forms of equity ownership to the ultimate natural person owners in determining whether such owners are accredited investors. Previously, this approach was not explicitly authorized by the accredited investor definition.
- *Rural business investment companies (RBICs).* As proposed, the Final Rule includes RBICs in the types of entities that are deemed accredited investors under Rule 501(a)(1).

Individual Accredited Investors

The Final Rule permits individuals to qualify as accredited investors based on certain professional certifications, designations, or other credentials (collectively, credentials) or, with respect to investments in a private fund, based on the person's status as a "knowledgeable employee" of the fund or certain of its affiliates. The Final Rule also modestly liberalizes the application of the joint net worth and income accreditation provisions, but it ultimately retains the 1982 net worth and income thresholds.

- *Certain Licensed Investment Professionals.* The Final Rule allows an individual holding in good standing certain investment-related credentials to qualify as an accredited investor, irrespective of that individual's net worth or income. As discussed below, for the present, this means certain holders in good standing of a subset of securities licenses will be deemed accredited under the Final Rule.

  Under the Final Rule, the SEC will designate qualifying credentials after considering a nonexhaustive list of factors. By separate, contemporaneous order, the SEC designated the General Securities Representatives license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative license (Series 65) as the initial qualifying credentials (the Initial Qualifying Credentials). In the Adopting Release, the SEC stated it would take a

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"measured approach" to further expanding the class of qualifying credentials and that it would designate further qualifying credentials on its own initiative only after gaining experience with the Final Rule.[14] Going forward, however, an institution or body who sponsors a program of study or credential, or a member of the public, may propose to the SEC a particular credential to be designated as a qualifying credential, leaving room for the eventual designation of, among others, the certified public accountant credential, juris doctorates, and other certifications relevant to the financial services industry.[15] The Final Rule also clarifies that, prior to the SEC issuing any final order designating a credential as qualifying, the SEC will provide notice and an opportunity for public comment.

An individual holding a qualifying credential need not practice in the fields related to that credential. However, as mentioned above, that individual must hold the credential in "good standing." In the context of the Initial Qualifying Credentials, this generally means that, in addition to passing the required examination, the individual must also be licensed or registered to conduct the business corresponding to the examination. For example, an attorney who is employed as in-house counsel by a registered investment adviser and who, incidental to his or her employment, has passed the Series 65 examination and is registered in one or more states as an investment adviser representative is an accredited investor under the Final Rule, even if he or she does not conduct investment adviser representative business.

- *Knowledgeable Employees Deemed Accredited Investors.* The Final Rule formally provides that "knowledgeable employees," as defined in Rule 3c-5 under the 1940 Act,[16] are accredited investors. Rule 3c-5 already provides that securities owned by knowledgeable employees shall be excluded in determining whether the securities of a Section 3(c)(7) fund are owned exclusively by qualified purchasers. The Final Rule will enable such employees to meet the accredited investor standard. Additionally, sponsors of Section 3(c)(1) funds will no longer be required to count their otherwise nonaccredited knowledgeable employee investors toward Rule 506(b)'s 35 nonaccredited investor limit. A knowledgeable employee's accredited investor status will extend to his or her spouse with respect to joint investments in relevant private funds.
- *Joint Net Worth and Income, Spousal Equivalents Expansion.* For purposes of the joint net worth requirement or joint income requirement under Rule 501(a), the Final Rule provides that "joint net worth" or "joint income" represents the aggregate net worth or income of the investor and his or her spouse or spousal equivalent (i.e., a cohabitant occupying a relationship generally equivalent to that of a spouse). It also provides that an investor relying on the Rule 501(a) joint net worth test need not purchase the relevant security jointly.
- *Net Worth and Income Thresholds Unchanged.* Consistent with the Proposed Rule, the current individual income (US$200,000) and net worth (US$1,000,000) thresholds will remain unchanged. The SEC concluded that it does not believe modifications to the thresholds are "necessary or appropriate" at this time, stating it is "not persuaded that the investor protections provided by the financial thresholds have been meaningfully weakened over time due to inflation."[17] The SEC also noted that changes over the years in areas other than inflation should be considered in evaluating the effectiveness of the accredited investor definition—for example, changes in the availability of information and advances in technologies: "Information about many issuers and other participants in the exempt markets is more readily available now [than in 1982] to a wide range of market participants."[18] In addition, the SEC cited concerns that

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indexing the wealth and income thresholds to inflation could have disruptive effects on companies offering their securities in reliance on Regulation D by significantly decreasing the accredited investor pool.

TAKEAWAYS

The SEC has characterized the Final Rule as a "modernization" of the accredited investor definition, and this is at least somewhat true, at least in a social and technological sense. As discussed in Section II.C., cohabiting unmarried couples may now pool their wealth or incomes to be deemed accredited investors. Similarly, the LLC, a legal form of entity in its infancy at Regulation D's inception, is now explicitly contemplated as a potential type of accredited investor. The Final Rule also seeks to bring the accredited investor definition in line with some (though not all) SEC regulations adopted over the past 38 years. For example, the Final Rule incorporates Rule 3c-5's knowledgeable employee concept (circa 1997, liberalized via 2014 guidance) and allows the spouses of knowledgeable employees to also be considered accredited investors for joint investment purposes. In addition, the Final Rule, in accrediting family offices managing at least US$5 million in investments and their family clients, adopts the policy considerations that animated the promulgation of Rule 202(a)(11)(G)-1 under the Advisers Act in 2011: such investors do not need all of the protections of the federal securities law, and their participation in certain kinds of investment activity (in this case, private offerings) should not be impeded.

This said, it may be more accurate to describe the Final Rule as primarily concerned with simply keeping the accredited investor pool open, more or less at the capacity it has been at for the past decade. While the Final Rule will undeniably expand the accredited investor pool, arguably the most meaningful change is the *absence of one*. Declining to modify the wealth and income thresholds applicable to individuals to account for inflation will mostly maintain the status quo. The SEC's refusal to radically expand the accredited investor pool by accrediting investors (other than family clients advised by certain family offices, as discussed in Section II.B.)[19] who purchase securities on the advice of third parties, such as investment advisers and broker-dealers, will similarly maintain the state of play. The same can be said of the SEC's failure to create a new category of accredited investor encompassing all qualified purchasers—it remains the case that certain investors meeting what could be considered a heightened standard will not necessarily be accredited investors, therefore leaving the size of the pool unaltered.[20]

Regardless of the SEC's ultimate policy aims, the Final Rule will benefit private funds relying on the exemption in Section 3(c)(1) of the 1940 Act.[21] In particular, the Final Rule's expansion of the accredited investor pool may stimulate Section 3(c)(1) fund sponsors' interest in and use of Rule 506(c) of Regulation D, which permits the offering of securities by general solicitation, provided that all purchasers are accredited investors and the issuer has taken "reasonable steps" to verify their accredited status (among certain other conditions).[22] Issuers have struggled to establish reliable accreditation verification processes, and the Final Rule's expansion and clarification of the bases of accreditation may help them overcome these challenges. It should be noted, however, that Section 3(c)(1) funds will remain subject to the applicable investor limits under the 1940 Act, which is generally 100 beneficial owners and, in the case of certain qualifying venture capital funds, 250 beneficial owners.

Separately, although not covered in depth in this Client Alert, the Final Rule includes conforming amendments to Rule 144A under the Securities Act, which expand the types of entities that may be deemed qualified institutional buyers (QIBs). These too can be viewed as neither radically expanding nor radically contracting the pool of QIBs. Much in the same way that the SEC declined to accredit all investors who are advised by investment advisers

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(who are now themselves accredited investors under the Final Rule), investors will continue to *not* be considered QIBs merely because they are advised by investment advisers that are QIBs themselves. As a result, managers of private funds will need to continue to ensure that all investors in such funds are QIBs in order to invest in Rule 144A securities, regardless of whether those managers are QIBs themselves.

FOOTNOTES

[1] The adopting release (the "Adopting Release") is available here. The Adopting Release also adopted certain conforming amendments to Rule 215, Rule 163B, and Rule 144A under the Securities Act.

[2] Our alert discussing the Proposed Rule can be found here. The proposing release (the Proposing Release) is available here.

[3] Specifically, any of the Series 7, Series 65, or Series 82 licenses. See Section II.C.

[4] For reference, had these thresholds been adjusted for inflation, the income threshold today would be in excess of US$500,000 for individuals (US$740,000 for a married couple) and the net worth threshold would be in excess of US$2.5 million. In 2011, to conform the accredited investor definition to the requirements of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the SEC amended the net worth test to exclude the value of an individual's primary residence when determining accredited investor status.

[5] In the Adopting Release, the SEC specifically noted investors newly accredited under the Final Rule will be able to participate in "investment opportunities that historically generally have not been available to them, such as . . . offerings by certain private equity funds, venture capital (VC) funds, and hedge funds . . . ." See Adopting Release, p. 98.

[6] In 2019, over US$2.7 trillion was raised in U.S. exempted securities offerings. Approximately US$1.6 trillion, or 57 percent of the total, was raised in offerings availing themselves of safe harbors available under Regulation D (specifically, under Rules 504, 506(b), and 506(c)). See Adopting Release, p. 110; *see also infra* note 22.

[7] While Rule 506(b) imposes no limit on the number of accredited investors to which securities may be sold, fund managers will likely wish to limit the number of record owners in a fund as necessary in order to avoid having to register a class of securities under the Securities Exchange Act of 1934.

[8] Rule 506(c), adopted in 2013, is a similar safe harbor, except that all purchasers in a Rule 506(c) offering must be accredited investors. Rule 506(c) also permits the use of general solicitation, while Rule 506(b) does not. *See infra* note 22. As noted below, irrespective of the Regulation D safe harbor a Section 3(c)(1) fund avails itself of, such fund remains limited to 100 beneficial owners (or in the case of a qualifying venture capital fund, 250 persons).

[9] Prior to the effective date of the Final Rule, an individual is an accredited investor only if that individual: (1) has income in excess of US$200,000 individually, or US$300,000 with a spouse, in the two most recent years preceding the transaction and must have a reasonable expectation of maintaining that same income level in the current year; (2) has net worth in excess of US$1 million, individually or with a spouse, without regard to the value of that individual's primary home; or (3) is a director, executive officer, or general partner of the private fund or of a general partner of the private fund. Also prior to the effective date of the Final Rule, certain enumerated entities, as provided in Rule 501(a), with over US$5 million in assets also qualify as accredited investors, while other

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entities, such as banks and registered investment companies, qualify without regard to the assets test.

[10] The next review is required to be conducted in or by 2023.

[11] *See* Adopting Release, p. 61.

[12] This last aspect of the catch-all provision likely will have the narrowest effect. As the SEC noted in the Proposing Release, trusts with investments of more than US$5 million will be able to rely on the catch-all category instead of existing Rule 501(a)(7) (accrediting any trust with more than US$5 million in assets whose purchases are directed by a sophisticated person). A sophisticated person would not need to direct the purchases of a trust relying on the catch-all.

[13] These factors include: (1) whether the credential arises out of examinations administered by a self-regulatory organization or educational institution, (2) whether such examinations are reasonably designed to demonstrate an individual's knowledge with respect to securities and investing, (3) whether the person with the credential can reasonably be expected to have sufficient knowledge to evaluate prospective investments, and (4) whether the credential is made publicly available or is otherwise independently verifiable. In the Proposed Rule, the fourth factor contemplated only credentials that are made publicly available, not credentials otherwise independently verifiable.

[14] *See* Adopting Release, p. 33.

[15] Many commenters on the Proposed Rule advocated for the inclusion of these credentials as qualifying credentials. *See* Adopting Release, pp. 14-26. The SEC did not declare it is opposed to the eventual inclusion of any of these credentials, only that it would move slowly to expand the universe of qualifying credentials *sua sponte*.

[16] Rule 3c-5(a)(4) under the 1940 Act defines a “knowledgeable employee” with respect to a private fund as any natural person who is: (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 (i.e., the fund's investment manager) of the private fund; or (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.

[17] *See* Adopting Release, pp. 73-74. The SEC also noted that when the wealth and income thresholds were adopted in 1982, an individual's primary residence could be included in the calculation of his or her net worth. The net worth calculation has excluded primary residence value since 2011, effectively increasing the net worth requirement without doing so numerically. *See supra* note 4.

[18] *See* Adopting Release, p. 73.

[19] In the Adopting Release, the SEC distinguished certain family offices and their family clients, who are accredited investors under the Final Rule, from other investors advised by third-party financial professionals, who

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are not automatically accredited investors under the Final Rule, primarily by virtue of the former's ability to absorb loss. See Section II.B. As noted in Section II.B., the Final Rule extends accredited investor status only to single-family offices with US$5 million in assets under management and family clients advised by such family offices.

[20] For example, certain irrevocable trusts with less than US$5 million in total assets or investments but for which each settlor and trustee is a qualified purchaser would satisfy the qualified purchaser standard pursuant to Section 2(a)(51)(A)(iii) of the 1940 Act, but they would not be accredited investors because they meet neither the greater than US$5 million in assets threshold under existing Rule 501(a)(7) nor the greater than US$5 million in investments threshold associated with the new catch-all category discussed in Section II.B.

[21] The Final Rule does not expand the qualified purchaser definition under the 1940 Act, which is relevant to sponsors of Section 3(c)(7) funds.

[22] Rule 506(b), which prohibits the use of general solicitation, remains the safe harbor of choice for issuers relying on Rule 506. Per the Adopting Release, nearly US$1.5 trillion was raised through Rule 506(b) offerings in 2019, while during the same time frame only US$66 billion was raised through offerings relying on Rule 506(c). *See* Adopting Release, p. 110.

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