SEC PROPOSES AMENDMENTS TO EXPAND DEFINITION OF ACCREDITED INVESTOR

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U.S. Investment Management Alert

By: Ruth E. Delaney, Pablo J. Man, Zachary A. Mason

I. INTRODUCTION

On December 18, 2019, the U.S. Securities and Exchange Commission ("SEC") proposed amendments to Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended ("Securities Act"), which would expand the definition of "accredited investor" (the "Proposed Rule"). [1] The Proposed Rule aims to permit a greater number of investors to participate in private 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, and extending the definition of accredited investor to include certain licensed professionals. [2] Notably, the Proposed Rule does not raise the standards for individual income ($200,000 for an individual, $300,000 for a married couple) or net worth ($1,000,000), which were established in 1982 and which some have argued have been eroded by inflation. [3]

As a practical matter, the Proposed Rule, if passed as written, will primarily benefit managers to private funds that are excepted from registration in reliance on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "1940 Act"), although the investor limit for such funds would continue to apply. Because the SEC has not proposed changes to the definition of "qualified purchaser," investors in private funds that rely on the exception in Section 3(c)(7) of the 1940 Act will continue to need to meet that higher standard.

The Proposing Release was published in the *Federal Register* on January 15, 2020, and comments must be submitted by March 15, 2020.

II. PROPOSED RULE

A. 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 non-exclusive 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 private fund sponsors.

Under Rule 506, an issuer generally may sell an unlimited amount of securities to (i) up to 35 non-accredited investors and (ii) an unlimited number of "accredited investors." [4] A purchaser is an accredited investor if an issuer "reasonably believes" that, at the time of the sale, the purchaser meets one of eight specific categories set

forth in Rule 501(a). [5] The definition of "accredited investor" is intended to provide objective standards of sophistication.

The Proposed Rule builds upon (1) a December 2015 SEC staff report, which examined the history of the accredited investor definition and considered recommendations for amending that definition ("2015 Report"); [6] and (2) a June 2019 SEC concept release, which solicited comments on ways to harmonize the exempt offering framework, including revisions to the accredited investor definition ("Concept Release"). [7] In the Proposing Release, the SEC specifically examined the findings in the 2015 Report and the comments submitted in response to Concept Release, and proposed to expand the definition of "accredited investor" as described below.

B. INDIVIDUAL ACCREDITED INVESTORS

The Proposed Rule adds new categories to the definition of accredited investor that would permit individuals to qualify as accredited investors based on certain professional certifications, designations or other credentials, or, with respect to investments in a private fund, based on the person's status as a "knowledgeable employee" of the fund.

- *Knowledgeable Employees Definition Clarified*. The Proposed Rule also clarifies some current ambiguity relating to the definition of "knowledgeable employees" in Rule 3c-5 under the 1940 Act. Rule 3c-5 allows certain employees of a fund or its manager [8] to invest in a Section 3(c)(1) fund without being counted for purposes of the 100-person limit or to invest in a Section 3(c)(7) fund regardless of whether the employee is a "qualified purchaser." However, because Rule 3c-5 addresses only eligibility requirements under the 1940 Act, there has been some uncertainty in the industry as to whether knowledgeable employees also need to separately satisfy the accredited investor eligibility requirement in the Securities Act. The Proposed Rule removes such uncertainty by explicitly allowing knowledgeable employees to qualify as accredited investors.

- *Joint Net Worth and Spousal Equivalents Expanded*. In addition, for purposes of the $1 million joint net worth requirement under Rule 501(a), the Proposed Rule would add a note that "joint net worth" represents the aggregate net worth of the investor and his or her spousal equivalent, which would encompass any cohabitants 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 would not need to purchase the security jointly.

- *Net Worth and Income Thresholds Unchanged*. Previously, the Concept Release requested comment on whether the SEC should revise the current individual income ($200,000) and net worth ($1,000,000) thresholds. In the Proposing Release, the SEC further considered these thresholds, noting that the figures have not been adjusted since 1982. The SEC concluded that it does not believe modifications to the thresholds are necessary at this time, but it has requested comments on whether the final should instead make a one-time increase to the thresholds in the account for inflation, or whether the final rule should reflect a figure that is indexed to inflation on a going-forward basis.

- *Certain Licensed Investment Professionals Would Automatically Qualify*. Consistent with the recommendation in the 2015 Report, the Proposed Rule would allow an individual with certain investment-related professional certifications, designations or other credentials (collectively, "credentials")

to qualify as an accredited investor. The designations would be set out by the SEC in an order, but they are anticipated to include the following:

- Licensed General Securities Representative (Series 7);
- Licensed Investment Adviser Representative (Series 65); and
- Licensed Private Securities Offerings Representative (Series 82).

The Proposed Rule also provides a non-exhaustive list of factors for the SEC to consider in issuing an order to include a designation, including whether (1) the credential arises out of examinations administered by a self-regulatory organization or educational institution: (2) such examinations are reasonably designed to demonstrate an individual's knowledge with respect to securities and investing: (3) the person with the credential can reasonably be expected to have sufficient knowledge to evaluate prospective investments; and (4) the credential is made publicly available. In addition, the individual would be required to maintain such credentials in good standing, if applicable.

C. ENTITIES QUALIFYING AS ACCREDITED INVESTORS

Additional Qualifying Entities. The Proposed Rule would expand the types of entities that may qualify as accredited investors under Rule 501(a), add a "catch-all" category for entities with $5 million in investments, clarify the current ownership look-through provision and permit certain family offices to qualify, as described below.

- *Family Offices*. In addition, the Proposed Rule would allow "family offices" with at least $5 million in assets under management and their "family clients" (as each term is defined under the Advisers Act) to qualify as accredited investors.
- *Limited Liability Companies ("LLCs")*. Codifying the position of the SEC staff, LLCs would be added to the list of entities enumerated in Rule 501(a)(3), such that LLCs with total assets in excess of $5 million would be considered accredited investors.
- *All Entities with $5 Million in Investments*. The Proposed Rule would also create a new "catch-all" category of accredited investors for entities with $5 million in investments that were not formed for the specific purpose of acquiring the offered securities. [9] This catch-all provision is intended to capture, among other types of entities, Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country. The SEC explained that requiring $5 million in investments, rather than in total assets, was consistent with the majority of comments submitted in response to the Concept Release and "may better demonstrate that the investor has experience in investing."
  - The SEC noted that this "catch-all" provision would obviate the need of irrevocable trusts with total assets in excess of $5 million to be directed by a sophisticated person, which is currently required under Rule 501(a)(7), and is seeking comment on whether the change is appropriate.
- *Registered Investment Advisers*. Under the Proposed Rule, investment advisers that are registered under Section 203 of the Investment Advisers Act of 1940, as amended ("Advisers Act"), or under state law (such registered investment advisers, "RIAs") would be deemed accredited investors. The SEC also requested comments on whether exempt reporting advisers should also qualify as accredited investors.

- Importantly, this new category would apply where the registered investment adviser is the investor of record but would not cover clients of the RIAs (except with respect to clients of certain family offices, as discussed below). By contrast, the Concept Release considered expanding the definition of accredited investor to include investors that are advised by a registered financial professional, such as a registered investment adviser or broker-dealer. [10] That proposal, however, was not included in the Proposed Rule. [11] Further, as described in Section IV, the Proposed Rule would not amend the definition of qualified institutional buyer ("QIB") under Rule 144A to include clients of an RIA that manages $100 million in assets.

- *Rural business investment companies ("RBICs")*. RBICs would also be included in the types of entities that are deemed accredited investors under Rule 501(a)(1). Similar to RIAs, the Proposed Rule does not impose a dollar thresholder and instead provides that an RBIC would qualify based solely upon its status as an RBIC.

- *Ownership Look-Through*. Currently, Rule 501(a)(8) permits an entity to qualify as an accredited investor if all of the entity's equity owners are accredited investors. Given that an equity owner of an entity may also be an entity rather than a natural person, the Proposed Rule would add a note to Rule 501(a)(8) to clarify 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.

IV. TAKEAWAYS

The Proposed Rule and conforming amendments are consistent with a recent trend to expand investor participation in private offerings, and the SEC's accompanying press release notes that the proposal is "an initial step in a broader effort to consider ways to harmonize and improve the exempt offering framework." To the extent that the Proposed Rule is passed in its current form, key takeaways include:

- Because the Proposed Rule does not expand the qualified purchaser definition, it will primarily benefit funds relying on the exception in Section 3(c)(1) of the 1940 Act. In that regard, while the Proposed Rule may help broaden the pool of potential investors, such funds will remain subject to the applicable investor limits, which is generally 100 beneficial owners and, in the case of certain qualifying venture capital funds, 250 beneficial owners.

- The SEC considered and declined to harmonize certain regulatory standards, including the definitions of accredited investor and qualified purchaser. By declining to define accredited investor to include any qualified purchaser, which is the framework for other standards like "qualified clients" under the Advisers Act and "qualified eligible persons" under CFTC Rule 4.7, the Proposed Rule may result in certain investors meeting what could be considered a heightened standard yet not being deemed accredited investors. For example, certain irrevocable trusts with less than $5 million in total assets 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 would not be accredited investors because they lack the $5 million threshold under Rule 501(a).

- Although the Proposed Rule clarifies the term "knowledgeable employees," managers should be mindful that the Proposed Rule will allow employees without significant assets to invest in private funds, including funds relying on the exception in Section 3(c)(7) of the 1940 Act.

- The Proposing Release includes conforming amendments to the types of entities that may be deemed QIBs pursuant to Rule 144A under the Securities Act. In the same way that the accredited investor definition does not include clients of RIAs, the SEC did not amend the definition of QIB to include clients of an RIA that manages $100 million in assets. As a result, managers to a private fund with less than $100 million in assets will need to continue to ensure that all investors in such private fund are QIBs in order to invest in Rule 144A securities.

NOTES

[1] The proposing release ("Proposing Release") is available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

[2] The SEC also proposed certain conforming amendments to Rule 215, Rule 163B and Rule 144A under the Securities Act.

[3] For reference, had these thresholds been adjusted for inflation, the income threshold today would be in excess of $500,000 for individuals ($740,000 for a married couple) and the net worth threshold would be in excess of $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 SEC amended the net worth test to exclude the value of an individual's primary residence when determining accredited investor status.

[4] However, as noted below, a Section 3(c)(1) fund would be limited to 100 beneficial owners (or in the case of a qualifying venture capital fund, 250 persons).

[5] Currently, an individual is only an accredited investor if that individual: (1) has income in excess of $200,000 individually, or $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 $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. Certain enumerated entities, as provided in Rule 501(a), with over $5 million in assets also qualify as accredited investors, while other entities, such as banks and registered investment companies, qualify without regard to the assets test.

[6] The 2015 Report is available at https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf. In October 2014, the SEC also held a meeting of its Investor Advisory Committee to discuss recommendations from various subcommittees, including recommendations on new standards for the definition of "accredited investor" for natural persons. *See* K&L Gates' client alert: SEC Receives Recommendations on Changes to Accredited Investor Definition (Oct. 10, 2014), available at http://www.klgates.com/sec-receives-recommendations-on-changes-to-accredited-investor-definition-10-10-2014/.

[7] The Concept Release is available at https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[8] 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 (i.e., the fund's investment manager) 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.

[9] The Proposed Rule would incorporate the definition of "investments" from Rule 2a51-1(b) under the 1940 Act.

[10] *See* Concept Release at 57-59.

[11] The SEC is seeking comment "on whether amending the accredited investor definition in this manner would provide sufficient investor protections and whether additional limitations on the types or amounts of investments or other conditions may be appropriate."

KEY CONTACTS

RUTH E. DELANEY
PARTNER

LOS ANGELES
+1.310.552.5068
RUTH.DELANEY@KLGATES.COM

PABLO J. MAN
PARTNER

BOSTON
+1.617.951.9209
PABLO.MAN@KLGATES.COM

