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The SEC Modernizes the "Accredited Investor" Definition

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On August 26, 2020, the Securities and Exchange Commission (SEC) adopted amendments to the definition of “accredited investor” to add new categories of natural persons and entities eligible to participate in our private capital markets and to make certain other modifications to the existing definition in Regulation D. According to the Final Rule release, the amendments are intended 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.” The SEC Final Rule is available here, the SEC’s press release announcing the adoption of the Final Rule is available here, and our prior blog post discussing the proposal of such rule is available here. The Final Rule will be effective in approximately 60 days.

The Commission vote broke along increasingly frequent philosophical lines. The two Democratic commissioners expressed concern that the SEC was abandoning its mission to protect potentially vulnerable investors for the sake of providing more access to capital for business. On the other hand, Chairman Clayton and the two Republican commissioners emphasized that the new rules were intended to allow more qualified investors to participate in private markets.

Historically, the test for who could qualify as an individual accreditor investor only took into account an individual’s income or net worth, i.e., only the wealthy qualified, and specifically included (i) any natural person whose individual net worth, or joint net worth with that person's spouse, excluding their primary residence, exceeded $1 million and (ii) any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and had a reasonable expectation of reaching the same income level in the current year. These levels have not been revised since they were adopted in 1982, which has been the most significant factor increasing the pool of individuals qualifying as accredited investors over that period.

Expanding eligibility has been on the SEC’s radar since at least 2015, when the SEC issued a report inviting public comments on numerous potential changes to the definition to broaden eligibility. In 2019, the SEC issued a concept release, which, among other things, included some quantitative analyses suggesting that the more highly educated,

upper-class in the Northeast and Western United States regions were more likely to be eligible under the prior definition of accredited investor. Our prior blog discussing the SEC's concept release from 2019 is available here. The Final Rule now addresses some of these concerns by providing access to more individuals and entities that may not meet certain thresholds but may nevertheless be equipped to protect themselves.

As to natural persons, the Final Rule expands the scope of accredited investors to allow for considerations of professional knowledge, experience or certifications, thereby allowing for more natural persons to qualify as individual accreditor investors. Specifically, the Final Rule allows for natural persons to qualify (i) based on certain professional certifications and designations or other credentials (including a series 7, 65 or 82 license), and (ii) 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 issuer of the securities being offered or sold for investments in the fund[1]. While there is a risk that not relying on financial thresholds may open the market to individuals who are less able to financially bear the risks of private investments, the SEC believes that these categories of natural persons indicate a level of financial sophistication in individuals sufficient for them to analyze these risks and appropriately make informed decisions regarding their financial interests. The SEC also provided for the possibility that additional professional certifications and designations may be added as qualifying credentials in the future.

With respect to "knowledgeable employees", such term will have the same definition as that in Rule 3c-5(a)(4), which includes, among other persons, (i) executive officers, directors, trustees, general partners, advisory board members, or persons serving similar capacities, of the private fund or an affiliated management person of the private fund, and (ii) employees of the private fund or an affiliated management person of the private fund (other than employees solely performing administrative functions) who, in connection with their duties, participate in the investment activities of such private fund for at least 12 months.

The Final Rule also expands the scope of entities that may qualify as accredited investors. The first such change is to address some long overdue updates. Historically, the most common means for an entity to qualify as an accredited investor has been Reg D Rule 501(a)(3), which applies to a corporation, trust or partnership with total assets in excess of $5 million. Notably absent from this definition is a limited liability company, a legal entity which came into existence after Regulation D was adopted, though subsequent SEC guidance had made it clear that it was possible for limited liability companies to qualify. The Final Rule codifies this guidance by adding a limited liability company to the list in section 501(a)(3).

In addition, SEC- and state-registered investment advisers, exempt reporting advisers[2], and rural business investment companies[3], all have the requisite financial sophistication as other accredited investors, are now included in the types of entities qualifying as accredited investors.

"Family offices" are also now included in the types of entities qualifying as accredited investors. The term "family offices" is defined by reference to Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940, and generally includes an entity that has no clients other than family clients, is owned and exclusively controlled by the family, and does not hold itself out as an investment adviser. The "family offices" category requires family offices to have at least $5 million in assets under management, and only applies to family offices that are not formed for the specific purpose of acquiring the securities offered and whose purchase is directed by an individual that has financial and business knowledge and experience. "Family clients" of a family office are also included as accredited investors if they meet the same requirements. The SEC believes that family offices and their family clients have the ability to sustain the risk of loss of investment given their assets.

The Final Rule also includes a new approach to defining entities that qualify as accredited investors. This investments-owned test is meant to serve as a catch-all by including all types of entities not already encompassed within Rule 501(a), such as Indian tribes, labor unions, governmental bodies and funds, and entities formed under the laws of a foreign country, as well as entity types that may be created in the future, so long as such entity owns investments in excess of $5 million and was not formed for the specific purpose of acquiring the securities being offered. The SEC believes that entities with this level of investments should have as much financial sophistication as other institutional accredited investors.

In another modernization aspect, the Final Rule allows natural persons to include joint income from spousal equivalents (a cohabitant occupying a relationship generally equivalent to that of a spouse) when calculating joint income under Rule 501(a)(6) and net worth under Rule 501(a)(5). This is to clarify the lack of a definition for "spouse" in Rule 501 and to provide clarity for persons in legally recognized unions, such as domestic partnerships.

In addition to expanding the scope of accredited investor, the "qualified institutional buyer" definition in Rule 144A is now also expanded to include rural business investment companies, limited liability companies, and entities that meet a $100 million in securities owned and invested threshold that qualify for accredited investor status to qualify as qualified institutional buyers.

By expanding the definition of "accredited investor" to include more than just the wealthy, the SEC is taking steps to modernize the securities laws to reflect developments in business practices and in society since the adoption of Regulation D, and to recognize that the wealthy are not the only ones that are able to protect themselves in private capital markets.

Footnotes

[1] A private fund is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Sections 3(c)(1) or 3(c)(7) of that Act.

[2] An exempt reporting adviser is an investment adviser that qualifies for the exemption from registration under Section 203(l) of the Advisers Act by nature of being an adviser to only one or more venture capital funds, or under Rule 203(m)-1 of the Advisers Act by nature of being an adviser with assets in the U.S. for less than $150 million to only private funds.

[3] A rural business investment company is defined in Section 384A of the Consolidated Farm and Rural Development Act as a company approved by the Secretary of Agriculture that has entered into a participation agreement with the Secretary.