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SEC Adopts Amendments to Accredited Investor Definition

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On August 26, 2020, the SEC [adopted amendments](#) to its definition of “accredited investor” that adds new categories of qualifying persons and entities (the “*Amendment*”). [1] The accredited investor definition is one of the main methods used to determine who may participate in private offerings (e.g., whether a prospective investor is permitted to buy private placements, private equity, venture capital, hedge funds) and is intended to identify those investors that have sufficient financial sophistication to assess and sustain the risk of loss of an investment without the heightened protections (beyond anti-fraud protection) afforded from Securities Act registration. [2]

Under the prior definition, a natural person’s qualification as an accredited investor was primarily based on wealth (either net worth or income). Individuals with such wealth were presumed to be financially sophisticated and able to bear the loss of investments. The Amendment establishes a new category of accredited investors based on education or licensing credentials, regardless of wealth. The SEC explained that financial sophistication can be shown in a variety of ways including the ability to assess investment opportunities. [3] Individuals with the approved credentials have demonstrated such ability. Prior to the Amendment, certain entities could qualify as an accredited investor based on the type of entity or institution or level of assets. The Amendment expands the types of entities that qualify as accredited investors.

The Amendment adds the following categories to the definition of accredited investor:

Natural Person Categories

- **Professional Certification.** Persons holding good standing of one or more professional certifications, designations, or credentials designated by the SEC. [4] The initial qualifying credentials are a Series 7, Series 82, or Series 65 license. [5]
- **Knowledgeable Employee.** Persons who are a “knowledgeable employee” [6] of a 3(c)(1) or 3(c)(7) fund. [7]
- **Spousal Equivalent.** An individual may use the income or net worth of a spousal equivalent when calculating joint income and joint net worth.[8] A spousal equivalent is a cohabitant occupying a relationship generally equivalent to that of a spouse. [9]
- **Clarification on Use of Joint Income and Wealth Tests.** The SEC clarified that use of the joint income or net worth standard does not require the securities be purchased jointly. [10]

Entity Categories

- ***New Entities (No Financial Threshold)***

- SEC or state registered investment advisers and exempt reporting advisers relying on Sections 203(l) or (m) (e.g., private fund or venture capital advisers); [11] and
- Rural Business Investment Companies. [12]

- ***New Entities (With Financial Threshold)***

- Limited liability companies with more than \$5 million in assets that were not formed for the specific purpose of acquiring the securities offered. [13]
 - "Family Offices" [14] (i) with at least \$5 million assets under management, (ii) that were not formed for the specific purpose of acquiring the securities offered, and (iii) whose investment is directed by a person with knowledge and experience in financial and business matters that is capable of evaluating the merits and risks of the investment. [15] A "family client" [16] of a family office also qualifies if their investment is directed by a family office. [17]
- ***Catch All.*** An entity (i) that is an entity type otherwise listed in the definition, (ii) that was not formed for the specific purpose of acquiring the securities offered, and (iii) owns investments [18] in excess of \$5 million. [19] This catch all is intended to capture existing entity types not already listed, like Indian tribes and governmental bodies, and any entity type that may be created in the future. [20]
 - ***Clarification on All Equity Owners Rule.*** The SEC acknowledged that in many instances the equity owner of an entity is another entity. The SEC is clarifying that issuers may look through entity ownership to the natural person owners because the intent of this rule is to qualify entities owned 100% by accredited investors, whether ownership is direct or indirect. [21] For example, if an equity owner of an entity is an entity that is not an accredited investor, like an LLC that does not meet the \$5 million threshold, but is owned by a natural person that meets the definition of an accredited investor, then an issuer may look through the non-accredited investor entity.

By adding new categories of qualifying persons and entities more individuals will be able to participate in private investment opportunities. Arguably, the Amendment acknowledges that wealth is not a determinative factor in demonstrating financial sophistication; however, the Amendment did not remove the wealth thresholds as a means of establishing accredited investor status, it merely added additional, different criteria for meeting the standard.

The Amendment effective date is 60 days after published in the federal register, meaning that it will become

effective sometime after October 31st, 2020.

If you have any questions about the accredited investor definition or private offerings, please feel free to contact us.

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Footnotes

[1] SEC, Final Rule: Amending the “Accredited Investor” Definition, available at <https://www.sec.gov/news/press-release/2020-191> [hereinafter referred as “Adopting Release”].

[2] *Id.* at 6.

[3] *Id.*

[4] Rule 501(a)(10). The SEC will designate additional certifications, designations, and credentials by order and maintain a list of qualifying certifications, designations, and credentials on their website. When designating a new qualifying credential the SEC will consider a number of factors including who administers and issues the credential, if the credential reasonably demonstrates sophistication in investing and ability to evaluate investments, and persons can independently verify whether a potential investor holds such designation. See Rule 501(a)(10).

[5] Adopting Release at 29.

[6] The accredited investor definition uses the definition of knowledgeable employee from [Rule 3c-5\(a\)\(4\)](#) of the Investment Company Act of 1940.

[7] Rule 501(a)(11).

[8] Rule 501(a)(5) and (6).

[9] Rule 501(j).

[10] See Note 1 to Rule 501(a)(5).

[11] Rule 501(a)(1).

[12] As defined in section 384A of the Consolidated Farm and Rural Development Act. Rule 501(a)(1).

[13] Rule 501(a)(3).

[\[14\]](#) As defined in [Rule 202\(a\)\(11\)\(G\)-1](#) of the Investment Advisers Act of 1940.

[\[15\]](#) Rule 501(a)(12).

[\[16\]](#) As defined in [Rule 202\(a\)\(11\)\(G\)-1](#) of the Investment Advisers Act of 1940.

[\[17\]](#) Rule 501(a)(13).

[\[18\]](#) As defined in [Rule 2a51-1\(b\)](#) of the Investment Company Act of 1940.

[\[19\]](#) Rule 501(a)(9).

[\[20\]](#) Adopting Release at 55.

[\[21\]](#) Id at 68. See Note 1 to Rule 501(a)(8).