

# SEC Proposes to Update “Accredited Investor” Definition

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On December 18, 2019, the SEC proposed to amend its definition of “Accredited Investor” with hopes to expand access to private capital markets to a wider range of investors.<sup>[1]</sup> The proposed changes create two new categories of natural persons who may be considered “accredited investors” and add to the categories of institutional investors who qualify. According to the SEC’s press release regarding the proposed changes, the purpose of the changes is to more effectively identify investors that have the “knowledge and expertise” to safely invest in private markets without the additional investor protections created by the filing requirements of the Securities Act of 1933 (the “Securities Act”).<sup>[2]</sup>

The proposed changes would also expand the definition of “Qualified Institutional Buyer” in Rule 144A, add the term “spousal equivalent” where an individual’s spouse is part of the Accredited Investor analysis, and make a few other clarifications.

The proposed changes were released on December 18, 2019, and will remain open for comment until March 16, 2020. This client alert only discusses the amended definition as proposed. The final adopted definition may differ from that which is discussed here.

## **New Categories of Accredited Investors**

Natural Persons: The proposed amendments would add the following categories of natural persons to the list of Accredited Investors:

- Individuals with certain professional certifications and designations.<sup>[3]</sup> The proposed definition includes individuals with a Series 7 license (general securities representative), Series 65 license (investment adviser representative), and Series 82 license (private securities offerings representative), each issued by the Financial Industry Regulatory Authority (“FINRA”).<sup>[4]</sup> Other credentials issued by an accredited educational institution could also be included if the credentials relate to securities and investing. These individuals would need to maintain an active license, but they would not need to actively continue practicing in the investments field in order to qualify as Accredited Investors; and
- “Knowledgeable Employees”<sup>[5]</sup> of Private Funds.<sup>[6]</sup> These individuals will be considered Accredited Investors with respect to the Private Fund for which the individual is a “Knowledgeable Employee.” Along with the fact that the SEC does not see the need to protect these investors through filing requirements, there is hope that this change will align these employees’ interests with their investors’ interests.

## Entities:

- The proposed amendments would add the following types of entities to the list of Accredited Investors:
  - Limited Liability Companies with assets of more than \$5 million<sup>[7]</sup> (the requirement currently applicable to corporations), as long as the Limited Liability Company was not formed for the specific purpose of investing in the securities;
  - Registered Investment Advisers,<sup>[8]</sup> whether registered under the Investment Advisers Act of 1940 or under state law;
  - Rural Business Investment Companies (“RBICs”),<sup>[9]</sup> regardless of their asset size or amounts under management<sup>[10]</sup>; and
  - “Family Offices” and their “Family Clients.”<sup>[11]</sup> as long as the Family Office has at least \$5 million in assets under management and the Family Office was not formed for the specific purpose of investing in the security. The definition applies to Family Offices whose purchase is directed by a person who can evaluate the merits and risks of the prospective investments through his or her knowledge and experience. The SEC expects that “all or most” Family Offices currently fit the proposed definition.
- The proposed changes also create a catch-all category for any entity that owns investments—not assets<sup>[12]</sup>—of more than \$5 million.<sup>[13]</sup> Again, this entity must not have been formed for the specific purpose of investing in the

securities offered. This proposal “is intended to capture all existing forms not already included within Rule 501(a), such as Indian tribes and governmental bodies, as well as those entity types that may be created in the future.”<sup>[14]</sup>

### Other Changes

Spousal Equivalents: Under the current rule, spouses can reach minimum net worth and income requirements jointly. The proposed amendments add “spousal equivalent” as a second type of person with whom an individual may jointly reach the minimum thresholds.<sup>[15]</sup> “Spousal equivalent” means “a cohabitant occupying a relationship generally equivalent to that of a spouse.”<sup>[16]</sup>

Joint Net Worth Calculations and Subsequent Purchases: The proposed amendments clarify that when an investor and his or her spouse (or spousal equivalent if the above section is adopted in the final definition) jointly reach the minimum net worth threshold, the securities do not need to be purchased jointly in order for the individual to be an Accredited Investor.<sup>[17]</sup>

“Qualified Institutional Buyer” Definition: The proposed amendments seek to expand the definition of “Qualified Institutional Buyer” as it is used in Rule 144A, which pertains to the resale of restricted securities.<sup>[18]</sup> Resales to Qualified Institutional Buyers that fit the Rule 144A safe harbor are exempt from the registration requirements of the Securities Act. The proposed amendments would expand the definition in the safe harbor to mirror the definition of “Accredited Investor,” although the applicable minimum threshold for Qualified Institutional Buyer status is \$100 million in securities owned and invested. The specific changes would be to add RBICs and Limited Liability Companies to the definition and create a catch-all provision for institutional Accredited Investors. All would still need to meet the \$100 million threshold.

Equity Ownership: The current rule states that if all of an entity’s equity owners are Accredited Investors, then that entity may be considered an Accredited Investor. In circumstances where an entity’s equity owner is another entity, the amendments would allow an entity to look through various levels of entity ownership to find natural person equity owners.<sup>[19]</sup> If all of those natural persons are Accredited Investors, then the entity in question may be considered an Accredited Investor as well.

No Changes to Financial Thresholds in Proposed Amendments: There are no changes to the minimum threshold requirements proposed in the amendments.

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<sup>[1]</sup> Press Release, Securities and Exchange Commission, SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments (Dec. 18, 2019).

<sup>[2]</sup> *Id.*

<sup>[3]</sup> Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,579–83 (proposed Jan. 15, 2020) (to be codified at 17 C.F.R. pt. 230).

<sup>[4]</sup> *Id.* At 2,581.

<sup>[5]</sup> “Knowledgeable Employees,” as defined in Rule 3c-5 of the Investment Company Act of 1940.

<sup>[6]</sup> Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,584–85.

<sup>[7]</sup> Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,587.

<sup>[8]</sup> *Id.* at 2,586.

<sup>[9]</sup> *Id.* at 2,586–87.

<sup>[10]</sup> RBICs are incorporated bodies, Limited Liability Companies, or limited partnerships that exist “solely for the purpose of performing the functions and conducting the activities authorized by the [Consolidated Farm and Rural Development Act].” Generally, the Consolidated Farm and Rural Development Act promotes economic development and job creation in rural areas by encouraging capital investments in smaller businesses and enterprises located in rural areas. At least 75% of an RBIC’s invested capital must be invested in “Rural Business Concerns,” (which are defined as “any company, organization, Indian tribe, or other person or entity that ‘primarily operates in a rural area’”) and no more than 10% of the investments may be made in an area with a city of over 150,000 or an urbanized area that contains the city or is next to the city.

<sup>[11]</sup> *Id.* at 2,589–90.

<sup>[12]</sup> This distinction is drawn to contrast the threshold for Corporations and Limited Liability Companies. Out of fear that the catch-all would be too broad, the SEC determined that entities with \$5 million worth of investments would be experienced and knowledgeable enough to not need Securities Act protections, whereas an entity with simply \$5 million of non-financial assets—such as motorized vehicles—and no investing experience would still need protection. See Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,588.

<sup>[13]</sup> Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,588.

<sup>[14]</sup> *Id.*

<sup>[15]</sup> *Id.* at 2,590.

<sup>[16]</sup> *Id.*

<sup>[17]</sup> Amending the “Accredited Investor” Definition, 85 Fed. Reg. 2,585.

<sup>[18]</sup> *Id.* at 2,596–98.

<sup>[19]</sup> *Id.* at 2,589.