ALERT MEMORANDUM

SEC Expands the Accredited Investor Definition

August 31, 2020

On August 26, 2020, the SEC voted 3-2 to adopt amendments[1] modernizing and expanding the definition of "accredited investor" (AI), which has remained largely unchanged since 1982. The final rule substantially tracks the SEC's proposal from December 2019[2] and will allow individuals to qualify as AIs based on professional certifications and experience that demonstrate financial sophistication, and expand the scope of covered institutions. AI status is a key requirement for eligibility to participate in private placements under the Securities Act, and the amendments will allow a broader range of individuals and institutions access to the private capital markets.

The AI definition has until now used wealth and institutional status as a proxy for financial sophistication sufficient to render the protection of Securities Act registration unnecessary. The amendments do not change the longstanding income and net worth thresholds for individuals, but expand the universe of qualifying natural persons to those who are able to assess the risks and merits of an investment opportunity based on their professional qualifications or role. The expansion of covered institutions codifies long-standing SEC guidance regarding the treatment of LLCs, and eliminates confusion about whether certain entities, such as sovereigns, Indian tribes and municipalities, qualify as AIs. The amendments also make corresponding changes to the definition of Qualified Institutional Buyer (QIB).

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[1] SEC Release No. 33-10824 (Aug. 26, 2020), available at https://www.sec.gov/rules/final/2020/33-10824.pdf.
[2] SEC Release No. 33-10734 (Dec. 18, 2019), available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf. You can read our alert memo on the proposal here.

The amendments mark the first rule changes adopted as part of a broader SEC initiative to simplify, harmonize and improve the exempt offering framework, as laid out in the SEC's 2019 concept release.[3] They also follow several incremental efforts to reconsider the longstanding definitions, including a 2007 proposal that ultimately was not adopted and a more recent 2015 staff report.

The final rule will become effective 60 days after publication in the Federal Register. The SEC did not indicate that voluntary early adoption of the rule would be permitted.

As adopted, the amendments will:

Natural Persons

— Allow individuals to qualify as AIs based on holding in good standing one or more qualifying professional certifications, designations or credentials.

- The SEC will designate qualifying certifications, designations or credentials by order based on consideration of a nonexclusive list of attributes, including whether:
  - they arise out of exams administered by a self-regulatory organization, industry body or issued by an accredited educational institution;
  - the exams reliably and validly demonstrate the requisite sophistication;
  - persons holding the certifications, designations or credentials can reasonably be expected to be able to evaluate the merits and risks of prospective investments; and
  - the holding of the certification or designation is publicly available or otherwise independently verifiable.
- Although unlikely to meaningfully expand the use of Rule 506(c), the ability to easily independently confirm whether an individual holds a qualifying certification, designation or credential may make taking reasonable steps to verify AI status (required if general solicitation is used and sometimes considered onerous by market participants) incrementally easier.
- By separate order,[4] the SEC initially designated the Series 7, Series 82 and Series 65 as qualifying licenses.
- The SEC may reevaluate previously designated certifications, designations or credentials if they change over time, and designate new ones that are consistent with the specified criteria following notice and opportunity for public comment, as appropriate.

— Treat "knowledgeable employees" (defined in Rule 3c-5(a)(4) under the Investment Company Act) of a private fund as AIs for investments in the fund (and affiliated funds), since such employees are presumed, by virtue of their positions, to have the requisite experience and access to information to make informed investment decisions with respect to the fund's offerings.

- This will also allow knowledgeable employees to invest in a fund that has $5 million or less of assets (and therefore does not independently qualify as an AI) without the fund losing its AI status.[5]
- A knowledgeable employee's AI status will be attributed to the employee's spouse with respect to joint investments in the fund.

[3] SEC Release No. 33-10649 (Jun. 18, 2019), available at https://www.sec.gov/rules/concept/2019/33-10649.pdf. The SEC's March 2020 proposal covering amendments to areas such as integration, general solicitation and offering communications, and Rule 506(c) verification requirement also forms part of this initiative, and you can read our alert memo on that proposal here.

[4] SEC Release No. 33-10823 (Aug. 26, 2020), available at https://www.sec.gov/rules/other/2020/33-10823.pdf.

[5] Under Rule 501(a)(8), a fund can qualify as an AI if all equity owners qualify as AIs.

- Because knowledgeable employee status generally turns on whether the employee has been performing the relevant functions or duties for 12 months, as contrasted to the two-year lookback for income-based AIs, this amendment can be particularly helpful in facilitating investments in private funds by new hires.

— Allow spousal equivalents to pool their finances for the purpose of qualifying as AIs.

Entities

— Add as AIs with no accompanying financial test (1) investment advisers registered under Section 203 of the Advisers Act, investment advisers registered under the laws of the various states and, in a change from the proposal based on comments received, exempt reporting advisers and (2) rural business investment companies (RBICs).

— Reflect longstanding SEC staff views and add LLCs to the list of enumerated entities that qualify as AIs if such entity owns at least $5 million in assets.

— Add a new "catch-all" category of AIs, covering any non-enumerated entity owning investments (as defined in Rule 2a51-1(b) under the Investment Company Act) in excess of $5 million, so long as not formed for the purpose of investing in the offered securities.

- The SEC decided against including an enumerated list of entities in order to maintain flexibility and to capture new entity types that may be created in the future. The adopting release made it clear that the SEC believes the term "entity" is broad enough to encompass Indian tribes, governmental bodies, funds and entities organized under the laws of foreign countries.
- The SEC concluded that an investment test (rather than the asset test used for certain enumerated entities) is the appropriate measure of financial sophistication for this catch-all provision, as certain covered entities, such as government bodies, may reach the $5 million asset threshold through ownership of non-financial assets such as land but have little or no investment experience.

— Add as AIs (1) "family offices" that have at least $5 million of assets under management, which were not formed for the specific purpose of acquiring the securities offered, and whose prospective investment is directed by a sufficiently sophisticated person, and (2) "family clients" of such "family offices" if (in a change from the proposal) the investment by the "family clients" is directed by the "family office" in accordance with the rule.

— Make corresponding changes to Rule 144A to expand the QIB definition to include registered investment advisers, exempt reporting advisers, RBICs, LLCs and institutional AIs not otherwise enumerated in Rule 144A so long as, in each case, Rule 144A's $100 million threshold for securities owned and invested is satisfied.

The SEC adopted conforming amendments to Rule 163B under the Securities Act and to Rule 15g-1 under the Exchange Act to accommodate the changes detailed above.

Overall, we believe the amendments are a sensible and welcome expansion of the existing AI and QIB definitions. We are disappointed the SEC ultimately did not allow investors advised by financial professionals, particularly when acting with discretion for a non-AI, to qualify for AI status. Similarly, we and others had suggested the SEC consider allowing a QIB, such as an SEC registered investment adviser, to act on behalf of an entity that is not a QIB – *e.g.*, a newly formed fund that does not yet have $100 million of securities on its balance sheet. The SEC declined to go beyond what they had originally proposed and did not add these provisions in the final rule. The adopting release also did not address suggestions made by certain commenters to allow unregistered investment vehicles to benefit from the ability, currently available only to registered investment companies, to aggregate

the amount of securities owned with affiliated investment vehicles for purposes of meeting Rule 144A's $100 million threshold. Finally, we and others believe that the SEC should allow natural persons with $5 million in investments (the test used for the new entity catch-all) to qualify as AIs, as we do not see a reason to distinguish entities from natural persons in this regard. A $5 million investment test is also used for purposes of the natural person qualified purchaser (QP) definition. While acknowledging the SEC's statement that the QP definition serves a different purpose than that of the AI definition, both are designed to indicate financial sophistication, and we believe the harmonization of the two definitions in this area would be helpful in reducing the burden of confirming AI status for natural persons who are already verified as QPs. We hope the SEC will consider these points in the future as part of its ongoing exempt offering initiative.

Commissioners Lee and Crenshaw issued a joint statement dissenting from the amendments, the latter's first public statement since she was sworn in on August 17, 2020. Their statement raised concerns, consistent with Commissioner Lee's objection to the December 2019 proposal, with the SEC's failure to update the 38-year-old financial thresholds for individuals;[6] index these thresholds to inflation going forward; and, from a process standpoint, address the lack of data on the private markets more broadly. The two Commissioners criticized the lack of a robust analysis of the impact on more vulnerable investors, especially seniors.

The SEC had solicited comments on adjusting the financial thresholds or indexing them to inflation, but ultimately declined make any changes, concluding that it is not necessarily true that the AI pool as a whole is less sophisticated today than in 1982, and that the enhanced availability of information and expansion of technology since 1982 should be considered alongside the impact of inflation when evaluating if changes are needed. The adopting release also highlighted the disruptive impact on the market that removing people from the AI pool would have.

However, it appears this question is far from settled. The adopting release noted that the SEC can consider additional changes in connection with their next required quadrennial review of the AI definition, which must occur in or by 2023. Commissioner Roisman's statement, while supporting the amendments, indicated a preference for eligibility based on knowledge and a lingering skepticism about the appropriateness of the existing financial thresholds (or any financial thresholds), and encouraged commenters and members of the public to continue providing feedback. Chairman Clayton, although supporting the SEC's position today, similarly acknowledged the tension and noted that in the future the SEC may be able to revisit the wealth tests and find a way to amend them while avoiding widespread market disruption. Commissioner Pierce also argued against the wealth tests, and indeed any tests, stating that while the amendments are a step in the right direction, they should have been much broader and investors should be allowed to make investment decisions based on their free choice, regardless of wealth or financial sophistication.

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[6] As noted in the dissenting statement, as a result of inflation there has been an increase of 550% in households that qualify as AIs since 1983.