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Memorandum

SEC Expands the Accredited Investor Definition

September 1, 2020

Last week, the Securities and Exchange Commission (the "**SEC**") adopted amendments to the "accredited investor" definition in Regulation D ("**Reg D**") under the Securities Act of 1933 (the "**Securities Act**").[1] In adopting these amendments, the SEC said it intended to update and improve the accredited investor definition to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in private capital markets.[2] Absent changes in its composition—always a likelihood after a Presidential election, the SEC is likely to take additional steps to modify the exempt offering framework, which could further enhance access to capital for private fund sponsors ("**Sponsors**").[3] This memorandum summarizes the amendments and highlights some key takeaways for Sponsors.

What Sponsors Need to Know

- **Overall Effect**: The expansion of the accredited investor definition modestly broadens the pool of potential investors for funds that conduct private offerings under Reg D, including Section 3(c)(1) funds (subject to the 1940 Act and Advisers Act limitations described below). For example, the amendments add "knowledgeable employees" of a private fund to the accredited investor definition.

[1] Amending the "Accredited Investor" Definition, Release Nos. 33-10824; 34-89669 (Aug. 26, 2020). The vote was 3-2, with both Democratic SEC Commissioners voting against the adoption of the amendments. In addition to amending Reg D, the SEC also amended Rule 144A, Rule 163B, and Rule 215 under the Securities Act as well as Rule 15g-1 under the Securities Exchange Act of 1934. Rule 144A provides a safe harbor exemption from Securities Act registration requirements for resales of certain restricted securities to "qualified institutional buyers" ("**QIBs**"). The amendments to Rule 144A add limited liability companies and rural business investment companies to the types of entities that are eligible for QIB status if they meet the $100 million in securities owned and invested threshold in the QIB definition. The amendments also permit institutional accredited investors under Reg D, of an entity type not already included in the QIB definition, to qualify as QIBs when they satisfy this $100 million threshold.

[2] According to the SEC's adopting release (the "**Adopting Release**"), the amendments are part of the SEC's broader effort to consider ways to simplify, harmonize and improve the exempt offering framework under the Securities Act. *See* Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649 (June 18, 2019) (seeking comment on "possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections").

[3] *See* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release Nos. 33–10763; 34–88321 (Mar. 4, 2020) (proposing amendments to various SEC rules that seek to address gaps and complexities in the exempt offering framework that may impede access to investment opportunities for investors and access to capital for issuers); *see also* Statement of Chairman Jay Clayton at Open Meeting (Dec. 18, 2019) ("I expect more to come in this space in the coming months, including examining whether appropriately structured funds can facilitate greater Main Street investor access to private investments, particularly as a component of an investment portfolio that is analogous to the portfolio of a well-managed pension fund."); and Speech: PLI Investment Management Institute, Dalia Blass (July 28, 2020) (stating that it is important to consider ways of enhancing retail investor access to private markets strategies and soliciting industry feedback on how registered closed-end funds structured to invest in private funds can provide access to these types of strategies in a manner consistent with the SEC's investor protections goals). For a discussion of Director Blass' speech on expanding access to private markets, *see SEC Signals Willingness to Expand Retail Investor Access to Private Markets Strategies Through Registered Funds of Private Funds*, Simpson Thacher Memorandum (July 29, 2020).

- **New Categories of Accredited Investors**: The SEC has expanded the accredited investor definition to include:
  - natural persons who hold certain professional certifications or designations or other credentials;
  - "knowledgeable employees" of a private fund;
  - "family offices" with at least $5 million in assets under management and their "family clients";
  - SEC- and state-registered investment advisers;
  - exempt reporting advisers;
  - rural business investment companies;
  - any entity with investments in excess of $5 million that was not formed for the specific purpose of investing in the securities offered; and
  - spousal equivalents that pool their finances for purposes of the income and net worth thresholds set forth in the definition.[4]
- **No Increase in Accredited Investor Financial Thresholds**: Notably, the SEC did not increase the financial thresholds set forth in the accredited investor definition (*e.g.*, the $5 million "total assets" threshold that certain persons must exceed to qualify as accredited investors).[5]
- **Subscription Document Changes**: Sponsors should update the accredited investor certifications in their fund subscription documents to reflect the changes made to the accredited investor definition (as applicable).
- **Effect on Rule 506(c) Offerings**: Some of the new accredited investor categories introduced by the amendments are based on easily verifiable criteria, such as whether a natural person investor holds a Series 7, 65, or 82 license. Reliance on Rule 506(c) could, as a result, become a more attractive path for certain Sponsors, as Rule 506(c) issuers can easily verify the accredited investor status of investors that fall within these new categories.[6]
- **No Material Effect on 3(c)(7) Funds**: The rule changes do not significantly increase the pool of eligible third-party investors for funds that rely on Section 3(c)(7) of the Investment Company Act of 1940 (the "**1940 Act**"). The scope of who meets the "qualified purchaser" definition under the 1940 Act remains largely unchanged,[7] and the vast majority of qualified purchasers already qualify as accredited investors under the current framework.

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[4] In addition, the amendments codify certain SEC staff interpretive positions relating to the definition.

[5] The two dissenting Democratic SEC Commissioners argued that these thresholds should have been increased.

[6] Issuers relying on Rule 506(c) of Reg D are required to take reasonable steps to verify the accredited investor status of each purchaser of securities sold in the offering, as discussed in more detail below.

[7] Pursuant to Rule 2a51-1 under the 1940 Act, a QIB, as defined in Rule 144A, acting for its own account, the account of another QIB, or the account of a qualified purchaser, is deemed to be a qualified purchaser for purposes of the Section 3(c)(7) exclusion, with two exceptions that relate to registered dealers and employee benefit plans. For this reason, the SEC's amendments to the QIB definition indirectly affect the qualified purchaser definition. *See supra* note 1 (discussing the amendments to the QIB definition). However, these changes do not meaningfully expand the qualified purchaser definition.

- **Other Considerations**: Sponsors are reminded that investors in private funds that pay carried interest or performance fees may need to be "qualified clients," as defined in Rule 205-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**"), to ensure compliance with Section 205(a)(1) of that Act.[8] Last week's rule changes do not revise the qualified client definition.
- **Compliance Date**: The amendments will go into effect in December (60 days after publication in the Federal Register, which has not yet occurred as of the date of this memorandum).

Amendments to the Accredited Investor Definition

BACKGROUND

Rule 506(b) of Reg D provides a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts transactions by an issuer "not involving any public offering" from Securities Act registration requirements. Pursuant to this safe harbor, an issuer may offer and sell an unlimited amount of securities, provided that offers are made without the use of general solicitation or general advertising and sales are made only to accredited investors and up to 35 non-accredited investors who meet an investment sophistication standard.[9]

The accredited investor definition, set forth in Rule 501(a) of Reg D, has historically included various categories of natural persons and entities. Broadly speaking, the definition has covered (i) natural persons whose net worth or income exceeds specific thresholds, (ii) certain types of entities with total assets in excess of $5 million, (iii) specific types of institutional investors, such as banks and insurance companies, and (iv) any entity in which all of the equity owners are accredited investors.

The SEC's amendments to the accredited investor definition are detailed below.

NATURAL PERSONS WITH PROFESSIONAL CERTIFICATIONS AND DESIGNATIONS AND OTHER CREDENTIALS

The accredited investor definition includes a natural person who has (i) an individual or joint net worth, with that person's spouse, that exceeds $1 million or (ii) an annual individual income exceeding $200,000 in each of the two most recent years, or joint income with that person's spouse exceeding $300,000 in each of those years, and

[8] The definition of "qualified client" in Rule 205-3 includes, among other things, a company that, immediately after entering into the investment advisory contract, has at least $1 million under the adviser's management and a company that, immediately prior to entering into the contract, has a net worth of more than $2.1 million. Investors do not typically need to be "qualified clients" in order to invest in business development companies ("**BDCs**") because Section 205(a)(1) does not apply to investment advisory contracts with BDCs that meet certain conditions.

[9] In addition, issuers relying on Rule 506(b) that sell securities to a non-accredited investor must first furnish to the investor certain specific information "to the extent material to an understanding of the issuer, its business and the securities being offered." Such information includes, in cases where the issuer is not eligible to use Regulation A under the Securities Act, "the same kind of information as required in Part I of a registration statement filed under the Securities Act on the form that the issuer would be entitled to use." 17 CFR 230.502(b). Rule 506(c) of Reg D provides another safe harbor under Section 4(a)(2) pursuant to which offers may be made through general solicitation or general advertising, provided that the purchasers in the offering are limited to accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors.

has a reasonable expectation of reaching the same income level in the current year.[10] Prior to the amendments, a natural person who failed to exceed these net worth and income thresholds generally did not qualify as an accredited investor, unless he or she was a director, executive officer,[11] or general partner of the issuer or of the issuer's general partner.

The amendments broaden the pool of natural persons who qualify as accredited investors. In particular, the amended accredited investor definition will extend to natural persons who hold in good standing a professional certification or designation or credential from an accredited educational institution that the SEC has designated as qualifying an individual for accredited investor status, regardless of their net worth or income. In determining whether a particular certification, designation, or credential should qualify an individual for accredited investor status, the SEC will consider a non-exclusive list of attributes, which will include, among other things, whether the certification, designation, or credential arises out of an examination (or series of examinations) designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing.[12]

The SEC has designated in a separate order Series 7, 65, and 82 licenses as qualifying an individual for accredited investor status.[13] To the extent the SEC designates other certifications, designations, or credentials as qualifying credentials in the future,[14] such designations will be made by means of an order, though the SEC will provide public notice and an opportunity for public comment before it issues any such order. The SEC will post on its website a list of all certifications, designations, and credentials it has recognized as qualifying an individual for accredited investor status.

[10] For purposes of the net worth test, a person's primary residence is not included as an asset.

[11] Rule 501(a) defines "executive officer" as "the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer." An "executive officer" of an issuer's subsidiary may be deemed an "executive officer" of the issuer if he or she performs such policy making functions for the issuer. The SEC staff has provided guidance regarding the definition of "executive officer" in Rule 3c-5 under the 1940 Act, which is substantially similar to the "executive officer" definition in Rule 501(a). *See, e.g.*, Managed Funds Association, SEC Staff No-Action Letter (Feb. 6, 2014) (expanding the interpretation of the "knowledgeable employee" definition in Rule 3c-5).

[12] This non-exclusive list of attributes includes the following: (i) the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution; (ii) the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing; (iii) persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and (iv) an indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

[13] Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status Pursuant to Rule 501(a)(10) under the Securities Act of 1933, Release No. 33-10823 (Aug. 26, 2020).

[14] The SEC suggested in the Adopting Release that it would only consider other credentials or designations after first gaining experience with the revised rules.

KNOWLEDGEABLE EMPLOYEES

The amendments add, as a new category of accredited investor, any natural person who is a "knowledgeable employee," as defined in Rule 3c-5 under the 1940 Act,[15] with respect to the issuer of the securities being offered or sold where the issuer would be an "investment company," as defined in Section 3 of such Act, but for the definitional exclusion provided by either Section 3(c)(1) or 3(c)(7) of such Act.[16]

Private funds typically rely on the definitional exclusions set forth in Sections 3(c)(1) and 3(c)(7) to operate without registering as investment companies under the 1940 Act. To rely on the Section 3(c)(1) exclusion, the number of beneficial owners of a fund's outstanding securities (other than short-term paper) must not exceed 100 persons. To rely on the Section 3(c)(7) exclusion, a fund's outstanding securities must be owned exclusively by persons who, at the time of acquiring such securities, are "qualified purchasers,"[17] as defined in Section 2(a)(51) of the 1940 Act.[18] Rule 3c-5 permits a "knowledgeable employee" of a private fund to invest in a Section 3(c)(1) fund without being counted in the 100 beneficial owner limitation and to invest in a Section 3(c)(7) fund without being a "qualified purchaser."

Under the prior definition, a natural person only qualified as an accredited investor if he or she either (1) passed the net worth test or income test set forth in the definition or (2) was a director, executive officer, or general partner of the issuer or of the issuer's general partner. A situation could have arisen where a knowledgeable employee (within the meaning of Rule 3c-5) of a particular private fund, which was offered exclusively to accredited investors for Reg D compliance purposes, did not pass the net worth test or income test and was not a director, executive officer, or general partner of the fund or of the fund's general partner. The knowledgeable employee, in that situation, would not have been an accredited investor under the prior definition and would have

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[15] Rule 3c-5 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 thereof; and (ii) an employee of the private fund or an affiliated management person thereof (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 thereof, or substantially similar functions or duties for or on behalf of another company for at least 12 months. Rule 3c-5 defines an "affiliated management person" with respect to a private fund as an "affiliated person," as defined in the 1940 Act, that manages the fund's investment activities.

[16] The SEC indicated in the Adopting Release that it believes it is appropriate to attribute a knowledgeable employee's accredited investor status to his or her spouse with respect to joint investments made by the knowledgeable employee and his or her spouse in a private fund. The Adopting Release also clarifies that the amendments do not limit accredited investor status to only those knowledgeable employees making investments in the private fund of which they participate in the management. The Adopting Release states, more generally, that "[this] new category of accredited investor will be the same in scope as the definition of "knowledgeable employee" in Rule 3c-5(a)(4)." Notably, the SEC staff has issued guidance endorsing an expansive interpretation of the Rule 3c-5 "knowledgeable employee" definition. *See* Managed Funds Association, *supra* note 11.

[17] The definition of "qualified purchaser" in Section 2(a)(51), broadly speaking, includes (i) natural persons who own not less than $5 million in investments, (ii) family-owned companies that own not less than $5 million in investments, (iii) certain trusts, and (iv) persons, acting for their own accounts or the accounts of other qualified purchasers, who in the aggregate own and invest on a discretionary basis, not less than $25 million in investments.

[18] In addition, the Section 3(c)(1) and Section 3(c)(7) exclusions only cover funds that are not making, and are not presently proposing to make, a public offering of their securities.

been unable to invest in the private fund. By contrast, this knowledgeable employee does qualify as an accredited investor under the amended definition.

FAMILY OFFICES AND FAMILY CLIENTS

The amendments add a new category of accredited investor for any "family office," as defined in Rule 202(a)(11)(G)-1 under the Advisers Act, with assets under management in excess of $5 million, so long as (a) the family office was not formed for the specific purpose of acquiring the securities offered and (b) its prospective investment is directed by a person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment. A family client, as defined in Rule 202(a)(11)(G)-1, of a family office meeting the aforementioned conditions and whose prospective investment in the issuer is directed by such family office would also qualify as an accredited investor.[19]

Under Rule 202(a)(11)(G)-1, a "family office" generally is a company whose sole clients are "family clients," and "family clients" generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities.[20] The SEC had received comments noting that circumstances had existed where family offices did not fall within the prior accredited investor definition.[21] Under the amended definition, any family office is an accredited investor if the conditions discussed above are met.

OTHER NEW CATEGORIES OF ACCREDITED INVESTORS

Registered Investment Advisers: The definition has historically enumerated specific types of institutional investors that qualify as accredited investors regardless of the total amount of assets they own. The amendments expand this list of institutional investors to include all SEC- and state-registered investment advisers. Such investment advisers, when investing for their own account, will qualify as accredited investors based on their status alone.

Exempt Reporting Advisers: The amendments also add exempt reporting advisers to the list of institutional investors that qualify as accredited investors when investing for their own account. An exempt reporting adviser is an investment adviser that qualifies for either the exemption from Advisers Act registration that is available to an adviser solely to one or more venture capital funds or the exemption from Advisers Act registration that is

[19] The Adopting Release explains that a family client will not qualify as an accredited investor with respect to a prospective investment if the family client's prospective investment is not directed by a family office meeting the aforementioned conditions.

[20] In addition, to fall within the "family office" definition, a company also (1) must be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members or family entities (each as defined in the rule) and (2) must not hold itself out to the public as an investment adviser. Rule 202(a)(11)(G)-1 defines "family member" to include all lineal descendants of a common ancestor and such lineal descendants' spouses or spousal equivalents, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. The "family office" definition does not extend to multi-family offices.

[21] *See* Letter from Private Investor Coalition dated September 24, 2019 (noting that "a trust for the benefit of a child or a charitable foundation that is formed and managed by a sophisticated investor may be a [q]ualified [p]urchaser but not an [a]ccredited [i]nvestor if the trust or foundation does not have sufficient assets").

available to an adviser solely to private funds and that has assets under management in the United States of less than $150 million.

Rural Business Investment Companies: Rural business investment companies ("**RBICs**"), as defined in Section 384A of the Consolidated Farm and Rural Development Act, are not currently included in the list of institutional investors that qualify as accredited investors based on their status alone. The amendments add RBICs to this list. As a result, all RBICs will qualify as accredited investors.

Catch-All Category for Entities Meeting an Investments-Owned Test: The amendments create a new catch-all category of accredited investor for any entity that owns "investments" in excess of $5 million and is not formed for the specific purpose of acquiring the securities offered. The amendments incorporate the definition of "investments" in Rule 2a51-1(b) under the 1940 Act.[22] This catch-all category is intended to capture all existing entity forms that were not already included in the prior definition, such as Indian tribes and the divisions and instrumentalities thereof, federal, state, territorial, and local governmental bodies, sovereign investment funds, and entities organized under the laws of a foreign country, as well as those entity types that may be created in the future.

PERMITTING SPOUSAL EQUIVALENTS TO POOL FINANCES FOR THE INCOME AND NET WORTH TESTS

The accredited investor definition covers (i) a natural person whose joint net worth with that person's spouse is greater than $1 million and (ii) a natural person who had joint income with that person's spouse in excess of $300,000 for each of the two most recent years and has a reasonable expectation of reaching the same income level in the current year. The SEC had noted uncertainties regarding whether persons in legally recognized unions, such as domestic partnerships, civil unions, and same-sex marriages, are considered spouses for purposes of the definition.[23]

To resolve these uncertainties, the amendments introduce the term "spousal equivalent," which will be defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse." Under the amended definition, a natural person will qualify as an accredited investor if (1) the person's joint net worth with his or her spousal equivalent exceeds $1 million or (2) the person's joint income with his or her spousal equivalent exceeds $300,000 in each of the two most recent years and the person has a reasonable expectation of reaching the same income level in the current year.

[22] The definition of "investments" in Rule 2a51-1(b) generally includes, among other things: securities; real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents held for investment purposes. The term does not cover non-financial assets, such as land, buildings, and vehicles.

[23] *See* Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015).

CODIFYING SEC STAFF INTERPRETIVE POSITIONS

Joint Net Worth: As described above, a natural person whose joint net worth with the person's spouse exceeds $1 million qualifies as an accredited investor. The SEC staff has provided guidance that, for purposes of this test, joint net worth can be the aggregate net worth of an investor and the investor's spouse, property need not be held jointly between spouses to be included in the joint net worth calculation, and the securities being purchased by an investor relying on the joint net worth test need not be purchased jointly with the investor's spouse for the investor to qualify as an accredited investor.[24] The amendments add a note to the definition that codifies this staff interpretation, though the note will reference not only spouses but also spousal equivalents.

Limited Liability Companies: The accredited investor definition includes a category for any organization described in Section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership that (i) has total assets in excess of $5 million and (ii) was not formed for the specific purpose of acquiring the securities offered. Although this category historically did not explicitly reference limited liability companies, the SEC staff had taken the position that limited liability companies that satisfy the two conditions set forth in this category were eligible to qualify as accredited investors.[25] The amendments codify this SEC staff interpretation.[26]

Look Through Guidance: The definition includes an entity in which all of the equity owners are accredited investors. The SEC staff had indicated that in a situation where a prospective purchaser is owned by an entity that does not qualify as an accredited investor on its own merits, the issuer may look through the owner-entity to its natural person owners to determine whether they are all accredited investors under the definition.[27] The amendments add a note to the definition that codifies this staff interpretation.

CONCLUSION

The amendments could be the beginning of a broader trend toward greater access to capital for Sponsors. We encourage Sponsors to assess the practical impact that the amendments will have on their fundraising activities. We stand ready to advise Sponsors with regard to their assessments of the impact of the amendments on their activities.

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[24] *See* Question 255.11 of Securities Act Rules Compliance and Disclosure Interpretations dated January 26, 2009.

[25] *See* Division of Corporation Finance interpretive letter to Wolf, Block, Schorr, and Solis-Cohen (Dec. 11, 1996).

[26] In the Adopting Release, the SEC expressed the view that a manager of a limited liability company performs a policy making function for the limited liability company equivalent to that of an "executive officer" of a corporation and would therefore qualify as an accredited investor with respect to any securities offered by the limited liability company.

[27] *See* Question 255.06 of Securities Act Rules Compliance and Disclosure Interpretations dated January 26, 2009.

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