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SEC Proposes Amendments to the Definitions of Accredited Investor and Qualified Institutional Buyer

The U.S. Securities and Exchange Commission (the "SEC") has issued a release (the "Proposing Release") (available here) proposing amendments that expand the definitions of "accredited investor" ("AI") and "qualified institutional buyer" ("QIB"). The AI definition is used principally to determine to whom an offering can be marketed in a private placement under Rules 506(b) and 506(c) of Regulation D, and the QIB definition is used principally to determine to whom securities can be resold in a sale structured under Rule 144A.

The Proposing Release follows from a concept release published by the SEC in June 2019 (available here) that sought public comments on revisions to the AI definition as part of a larger effort to simplify, harmonize and improve the exempt offerings framework, as well an earlier SEC staff report on the review of the AI definition published in December 2015 (available here).

Below, we summarize the proposed new categories of AI, the proposed related rule changes and the proposed expanded list of eligible entities that qualify as QIBs. We note that no changes were proposed to the definition of "qualified purchaser" ("QPs") under the Investment Company Act of 1940 ("ICA") and, in fact, the Proposing Release notes that an AI will not necessarily qualify as a QP or under other regulatory standards set forth in SEC rules, and that QP status and such other regulatory standards are not designed to capture the same characteristics as the AI standard.

New Categories of Accredited Investors and Related Amendments

The following new categories of qualifying natural persons and entities would be added to the AI definition:

- ***Natural persons with certain professional certifications, designations or other credentials*** – the SEC proposes to include individuals holding certain specified professional certifications, designations or other credentials in new Rule 501(a)(10). Natural persons holding the following professional licenses initially would qualify:[1] Series 7 (licensed general securities

[1] The SEC would designate qualifying certifications and designations in a separate SEC order and would allow for public comment on any new designation before publishing the final order on the SEC website. The designation would be based on the following non-exhaustive list of criteria: (i) the qualifying certification or designation would have to be based on an examination administered by a self-regulatory organization, (ii) the examination should test the individual's knowledge related to securities and investing, (iii) individuals that hold the certification or designation "can reasonably be expected to have

representative), Series 65 (licensed investment adviser representative) and Series 82 (licensed private securities offerings representative). The SEC believes that individuals holding these certifications by virtue of passing the certification examinations would have the required knowledge of the securities laws that would allow them to make informed investment decisions without the need for additional protections under the securities laws. This may also make it easier for issuers to ascertain for purposes of Rule 506(c) offerings whether or not an individual meets the AI definition if he/she holds a designation or certification specified by an SEC order.

- ***Natural persons who are "knowledgeable employees" of a private fund and investing in that private fund*** – the SEC proposes to add in new Rule 501(a)(12) "knowledgeable employees" of a private fund as a new category of natural persons qualifying as AIs in relation to that fund, as it is of the view that, by virtue of their active involvement in the activities of a fund, such employees are sufficiently sophisticated financially to be able to make informed investment decisions. Trustees and advisory board members, or those undertaking similar functions, of a Section 3(c)(1) or 3(c)(7) fund as well as employees of a private fund who as part of their regular duties have participated in the fund's investment activities for at least 12 months would fall within the amended definition. Note that knowledgeable employees of a private fund would be deemed AIs only with respect to investments in that private fund. This proposed change would allow employees to invest in their private funds without the fund itself losing AI status (based on Rule 501(a)(8), which looks to the equity owners of an entity that would otherwise not qualify on its own as an AI when the fund has assets of $5 million or less).

- ***Registered investment advisers*** – the SEC proposes to add investment advisers registered under Section 203 of the Investment Advisers Act of 1940 ("IAA") and state registered investment advisers to Rule 501(a)(1).

- ***Rural business investment companies*** – the SEC proposes to add rural business investment companies ("RBICs") to Rule 501(a)(1).

- ***Limited liability companies*** – the SEC proposes to add limited liability companies to Rule 501(a)(3) as long as they meet the other requirements of the definition, namely, they have total assets in excess of $5 million and are not formed for the specific purpose of acquiring the securities being offered.

- ***Entities that meet an investments-owned test*** – the SEC proposes to add a "catch-all" category in new Rule 501(a)(9) that would cover entities that own investments in excess of $5 million, are not formed for the specific purpose of acquiring the securities being offered and otherwise are not covered

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sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment" and (iv) the self-regulatory organization would make publicly available information that an individual holds the required certification or designation.

by other subsections of Rule 501(a). This new category would include entities such as Indian tribes and government bodies as well as other entity types that may be formed in the future. For purposes of new Rule 501(a)(9), "investments" are defined in Rule 2a51-1(b) of the ICA.

- ***Certain family offices and family clients*** – the SEC proposes to add "family offices" with at least $5 million in assets under management in new Rule 501(a)(12), provided that such family offices are not formed for the specific purpose of acquiring the securities being offered and that the purchase of the securities is directed by a person who has knowledge and experience in financial matters. New Rule 501(a)(13) would cover family clients (as defined in Rule 202(a)(11)(G)-1 under the IAA) of a family office meeting the requirements of new Rule 501(a)(12).

- ***Spousal equivalents*** – the SEC proposes to revise Rules 501(a)(5) and 501(a)(6) to permit individuals to include joint income from "spousal equivalents" (not just joint income from a spouse, as is currently the case) when calculating the joint income thresholds.[2] "Spousal equivalent" would be defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse."

  Additionally, the SEC proposes to clarify that for purposes of the calculation of "joint net worth" in Rule 501(a)(5), net worth can be aggregated between the investor and his/her spouse (or "spousal equivalent" if the term is adopted) and that the securities purchased based on the joint net worth test may be purchased by the investor individually and do not need to be purchased jointly with the spouse (or the "spousal equivalent").

The following related amendments would be implemented in connection with the proposed changes to Rule 501(a):

- ***Rule 501(a)(8)*** – the SEC proposes to add a note to Rule 501(a)(8) that would explain that when confirming the AI status in an entity qualifying for such status based on the fact that all of its equity owners are AIs, in instances where one or more equity owners is/are an entity (rather than an individual) it would be acceptable to look through to natural persons and if such natural persons are determined to be AIs then the entity itself would also be treated as an AI.

- ***Rule 215*** – the SEC proposes to amend the definition of AI in Rule 215 in order to conform it to the new definition in Rule 501(a) by replacing the existing definition in Rule 215 with a cross-reference to the new definition in Rule 501(a), which would also cover any future amendments to Rule 501(a).

- ***Rule 163B*** – the SEC proposes to revise Rule 163B in order to expand the list of entities with whom an issuer may engage in test-the-water communications, with the aim of increasing the use of Rule

[2] Under Rule 501(a)(6), an individual will be considered an AI if together with a spouse he/she exceeds the $300,000 joint income threshold. Under Rule 501(a)(5), the qualifying threshold for an individual is $1 million joint net worth.

163B. Rule 163B would be amended to include a reference to the proposed new categories of AI in new Rule 501(a)(9) (any entity owning investments in excess of $5 million that is not formed for the specific purpose of acquiring the securities being offered) and new Rule 501(a)(12) (family offices with at least $5 million in assets under management that were not formed for the specific purpose of acquiring the securities being offered).

- ***Exchange Act Rule 15g-1*** – Rule 15g-1 exempts broker-dealers that engage in "penny stock" transactions with customers that are "institutional accredited investors" (defined by reference to subparagraphs (1), (2), (3) or (7) of Rule 501(a)) from the requirement to disclose certain specified information. The SEC proposes to expand the list of "institutional accredited investors" that fall within Rule 15g-1 by adding a reference to the proposed categories of AIs in new Rules 501(a)(9) and 501(a)(12), as it is of the view that these types of investors would not need the additional information as they have good understanding of the risks that penny stock type transactions carry and they can process effectively the information regarding such securities.

Amendments to the Definition of QIBs

The QIB definition would be expanded by making certain conforming changes with the proposed changes to Rule 501(a). More specifically, the following new categories of qualifying entities would be added:

- ***Rural business investment companies and limited liability companies*** – Rule 144A(a)(1)(i) provides a list of the types of entities that qualify for QIB status as long they meet the threshold of at least $100 million in securities owned and invested. The SEC proposes to expand this list by adding RBICs to Rule 144A(a)(1)(i)(C) and limited liability companies to Rule 144A(a)(1)(i)(H).

- ***"Catch all" category*** – the SEC proposes to add a new subsection (J) to Rule 144A(a)(1)(i) that would permit institutional AIs under Rule 501(a) that do not otherwise qualify for QIB status to be QIBs as long as they satisfy the $100 million threshold. This would cover any new types of entities that would be covered by the AI definition in the future.

Next Steps

Market participants have 60 days following the publication of the proposed amendments in the *Federal Register* to submit comments.

As subscription agreements used for offerings of interests in private funds, as well as investor letters and other documents distributed in connection with private placements, tend to set out in full the definitions of AI and QIB (often with checkboxes), and these documents as well as indentures, offering memorandums and securities law legends typically make specific reference to "accredited investors within the meaning of sub-paragraphs (1), (2), (3) or (7) of Rule 501(a)" when intending to cover institutional accredited investors

as there is no technical definition of "institutional accredited investor," practitioners would be well advised to begin identifying the agreements and other documents that would need to be modified to reflect the changes to the AI and QIB definitions.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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