August 31, 2020

SEC Amends Definitions of Accredited Investor and Qualified Institutional Buyer

On August 26, 2020, the SEC adopted final amendments to the definitions of "accredited investor" ("AI") and "qualified institutional buyer" ("QIB") to include new AI categories of natural persons and entities and an expanded list of eligible entities that qualify as QIBs. The AI definition is used principally to determine to whom securities can be marketed in private placements 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 SEC adopting release (the "Adopting Release") (available here) follows from the proposing release published by the SEC in December 2019, which was based on a July 2019 concept release that sought public comment on revisions to the AI definition as part of a larger effort to simplify, harmonize and improve the exempt offerings framework.

The final amendments will become effective 30 days after the date of publication of the Adopting Release in the *Federal Register*.

Amendments to the Definition of Accredited Investor, and Related Changes

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

- ***Natural persons who are "knowledgeable employees" of a private fund and are investing in that private fund*** – "knowledgeable employees" of a private fund (as defined in Rule 3c-5(a)(4) of the Investment Company Act) are included as a new category of AI in new Rule 501(a)(11) in relation to that fund.

  Knowledgeable employees of a private fund are deemed AIs only with respect to investments in that private fund. This change allows 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 otherwise does not qualify on its own as an AI when it has assets of $5 million or less). With respect to joint investments made by a knowledgeable employee and his or her spouse in a private fund, the amended rules attribute the knowledgeable employee's AI status to his or her spouse.

  The SEC declined to modify the AI definition to include qualified purchasers ("QPs") because most QPs already meet the definition of AI by virtue of the higher financial thresholds applicable to them. Moreover, an AI does not necessarily qualify as a QP or under other regulatory standards set forth in

SEC rules, and QP status and such other regulatory standards are not designed to capture the same characteristics as the AI standard.

- ***Registered investment advisers*** – all SEC- and state-registered investment advisers as well as investment advisers exempt from registration under Section 203(l) or Section 203(m) of the Investment Advisers Act of 1940 are included in the definition of AI in Rule 501(a)(1).

- ***Rural business investment companies*** – the amendments add rural business investment companies ("RBICs") to the definition of AI in Rule 501(a)(1).

- ***Limited liability companies*** – limited liability companies are included in the definition of AI in Rule 501(a)(3) as long as 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*** – new Rule 501(a)(9) provides a "catch-all" category of AI that covers 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 by other subsections of Rule 501(a). This new category includes entities such as Indian tribes and governmental bodies as well as other entity types that may be formed in the future. For purposes of Rule 501(a)(9), "investments" are defined in Rule 2a51-1(b) of the Investment Company Act. The SEC declined to adopt an asset test in lieu of an investment test in this new category as it views the investment test as a more reliable method of ascertaining whether an entity is likely to require protections afforded by Securities Act registration.

- ***Certain family offices and family clients*** – the amendments add "family offices" with $5 million or more in assets under management in new Rule 501(a)(12), provided that any such family office is 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 and business matters that the family office is capable of evaluating the merits and risks of the prospective investment.

  New Rule 501(a)(13) covers family clients (as defined in Rule 202(a)(11)(G)-1 under the Investment Advisers Act) of a family office that meet the requirements of Rule 501(a)(12) and whose prospective investment in the issuer is directed by such family office. A person who is not a family client who receives assets upon the death of a family member or key employee (or other involuntary transfer from a family member or key employee) will qualify as a family client for one year after the transfer; that beneficiary would not be able to purchase additional holdings unless he/she qualifies as an AI on another basis.

- ***Spousal equivalents*** –revised Rules 501(a)(5) and 501(a)(6) 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.[1] "Spousal equivalent" is defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse."

Additionally, the amendments clarify that for purposes of the calculation of "joint net worth" in Rule 501(a)(5), net worth can be aggregated with a spouse or spousal equivalent and securities purchased based on the joint net worth test can be purchased by the investor individually and do not need to be purchased jointly with the spouse or spousal equivalent.

Natural persons with certain professional certifications, designations or other credentials – new Rule 510(a)(10) adds natural persons who hold in good standing one or more professional certifications, designations or other credentials designated by the SEC as qualifying an individual for AI status. To comply with the good standing requirement, individuals holding the designated certifications or credentials must demonstrate that they have passed the required examinations and that they maintain the active certification or designation; however, they are not required to practice in the area related to their certification or designation (except to the extent that a continued affiliation with a firm is required to maintain the certification or designation). The SEC issued a separate order[2] designating the following professional licenses as qualifying natural persons for AI status under Rule 501(1)(10): General Securities Representative license (Series 7), Private Securities Offerings Representative license (Series 82) and Investment Adviser Representative license (Series 65).

The SEC declined to include other professional certifications, designations or credentials such as other FINRA exams in the initial order, as this will allow it to first test the new rules with only a limited, carefully selected number of certifications and credentials. However, as noted in the Adopting Release, additional qualifying professional certifications, designations and credentials may be designated by the SEC in the future based upon consideration of a non-exclusive list of specified attributes.[3] Under the final rules, natural persons are not permitted to self-certify that they have the requisite financial sophistication to be accredited investors.

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1 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.

2 *See* SEC Release No. 33-10823 (August 26, 2020) (available here).

3 The criteria are: (i) the qualifying certification/designation should 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/designation "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) the self-regulatory organization should make publicly available information that an individual holds the required certification/designation.

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

- ***Rule 501(a)(8)*** – a supplemental note is added to Rule 501(a)(8) to explain that, when confirming the AI status of an entity based on the fact that all of its equity owners are AIs, where one or more equity owners is/are an entity (rather than an individual) and that entity owner does not qualify on its own merits as an AI (*e.g.*, if the entity owner is an LLC that does not meet the $5 million assets test), it is acceptable to look through to the natural persons and if such natural persons are determined to be AIs and if all other owners of the entity are AIs then the entity itself is also treated as an AI.

- ***Rule 215*** – the definition of AI in Rule 215 is conformed to revised Rule 501(a) with a cross-reference, which also will cover future amendments to Rule 501(a).

- ***Rule 163B*** – Rule 163B is amended to expand the list of entities with whom an issuer may engage in test-the-water communications, by including a reference to the new categories of AI in Rules 501(a)(9) and Rule 501(a)(12), and Rule 501(a)(13) (for family clients that are institutions).

- ***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 list of "institutional accredited investors" that fall within Rule 15g-1 is revised to add a reference to the new categories in Rules 501(a)(9) and 501(a)(12), and Rule 501(a)(13) (for family clients that are institutions).

Amendments to the Definition of Qualified Institutional Buyer

The QIB definition now includes the following new categories of qualifying entities, in conformity with the changes made to Rule 501(a):

- ***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 amendments 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*** – new subsection (J) is added to Rule 144A(a)(1)(i) to 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 covers any new types of entities that may be covered by the AI definition in the future.

The SEC declined to expand the QIB definition to include additional categories of entities, such as "family clients," private funds with $100 million in gross asset value and their investment advisers, clients of SEC-

registered advisers that manage more than $100 million in securities, and clients of any SEC-registered investment advisers.

Practical Considerations

As we noted when the amendments were proposed, 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 should consider modifying subscription agreements and other documents to reflect the changes to the AI and QIB definitions.

Putting these Changes into Context

The amendments to the AI and QIB definitions, although modest in scope, are a welcome step towards the modernization of the two concepts that play a key role in determining investors' eligibility to participate in private securities offerings. The definitions have remained largely unchanged for over 35 years. Addressing the concerns that the expansion in the AI definition may lead to more private financings and fewer public companies, SEC Chairman Clayton noted that given the number of segments in private markets and the different types of private financings, these amendments should be perceived as a positive development and benefit, in particular for small, local businesses. As for the possibility that the amendments could result in fewer public companies, Chairman Clayton is of the view that "the change in the definition will provide clearly sophisticated individual investors with more opportunities to invest and to diversify their investment portfolios, but it will not substantially affect aggregate capital flows among participants in private and public markets."

Two other SEC Commissioners (Roisman and Hester) generally supported the amendments as a way to broaden access to private investment opportunities beyond the wealthiest members of the public to include those with sufficient financial knowledge. Both Commissioners were in favor of expanding the AI definition further to include knowledge-based eligibility (*e.g.*, SEC expert staff based on their knowledge of the securities laws)(Roisman) and other financially sophisticated individuals who may not have the designated certifications or credentials required by the revised rules but who may nevertheless have "experience, local knowledge, education, and investing acumen to build a balanced investment portfolio, to maximize the nest eggs they pass on to their children, or to invest in their own communities." (Hester)

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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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