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Practice Update

SEC Amends the Definition of Accredited Investor

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The Securities and Exchange Commission (SEC) announced on August 26, 2020, that they have adopted amendments to expand the definition of accredited investor, which has remained largely unchanged since it was adopted in 1982. The amendments were adopted to allow more investors to participate in investment opportunities that are not generally available to the public. SEC Chairman Jay Clayton noted in his public statement discussing the amendments that "[w]hen small and medium-sized businesses often, and increasingly, rely on local sources of capital, particularly at the seed and initial growth stages, these restrictions are limiting and almost certainly stifle opportunity."

Below are some noteworthy highlights from the amendments, which will become effective 60 days after publication in the Federal Register. Issuers should begin the process of reviewing and updating their accredited investor/qualified institutional buyer questionnaires and the representations and warranties in their purchase/subscription agreements.

Highlights of the Amendments

Knowledgeable Employees of Private Funds

The amendments add a new category to the accredited investor definition that would enable

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natural persons who are "knowledgeable employees" of a private fund to qualify as accredited investors for investments in the fund. Knowledgeable employees will be defined in the same manner as "knowledgeable employee" in Rule 3c-5(a)(4) of the Investment Company Act of 1940, which includes, among other persons, executive officers, directors, trustees, general partners and advisory board members, or persons serving in a similar capacity, of a Section 3(c)(1) or 3(c)(7) fund or an affiliated management person of the fund that oversees the fund's investments, as well as employees of the private fund or an affiliated management person of the fund (other than employees performing solely clerical, secretarial, or administrative functions) who, in connection with the employees' regular functions or duties, have participated in the investment activities of such private fund, affiliated management person or substantially similar duties or functions at another company for at least 12 months.

Persons Holding Professional Certifications and Designations or Other Credentials

In the final rule, the SEC noted "[they] continue to believe that relying solely on financial thresholds as an indication of financial sophistication is suboptimal, including because it may unduly restrict access to investment opportunities for individuals whose knowledge and experience render them capable of evaluating the merits and risks of a prospective investment—and therefore fending for themselves—in a private offering, irrespective of their personal wealth." Consistent with that belief, the amendments also add a new category to the accredited investor definition that allows natural persons to qualify based on certain professional certifications, designations or credentials that result from an examination by a self-regulatory organization or industry body or are issued by an accredited educational institution that demonstrate an individual's sophistication with and comprehension of securities and investing, which

the SEC may designate from time to time by order. In connection with the amendments, the SEC has designated by order holders in good standing of the Series 7, Series 65, and Series 82 licenses as natural persons qualifying as accredited investors. Under the final rule, the SEC now has the flexibility to re-evaluate previously recognized certifications, designations or credentials if they change over time and designate other certifications, designations or credentials that are consistent with the specified criteria and the SEC determines are appropriate.

New Categories for Certain Entities

The amendments also add a new category to the accredited investor definition for any entity, including but not limited to:

- limited liability companies,
- Indian tribes,
- labor unions,
- governmental bodies,
- funds, and
- entities organized under the laws of foreign countries,

that own "investments," as defined in Rule 2a51-1(b) under the Investment Company Act of 1940, in excess of $5 million and that were not formed for the specific purpose of investing in the securities offered.

Family Offices and Family Clients

Further, the amendments add a new category to the accredited investor definition for "family offices" as defined in 17 CFR § 275.202(a)(11)(G)-1 (the "family office rule") that meet the following additional requirements:

(i) it has at least $5 million in assets under management,

(ii) it is not formed for the specific purpose of acquiring the securities offered, and

(iii) 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.

The amendments also include "family clients" (as defined in the family office rule) of a family office that meet the requirements stated above, and whose prospective investment in the issuer is directed by such family office.

Conforming Amendments to Definition of Qualified Institutional Buyer

In order to conform with the changes to the accredited investor definition, the amendments also expand the qualified institutional buyer definition to include i) limited liability companies and rural business investment companies if they meet the $100 million in securities owned and invested threshold, and ii) institutional investors included in the accredited investor definition that are not otherwise enumerated in the definition of "qualified institutional buyer," provided they satisfy the $100 million threshold.

Other Amendments

The amendments also revise Rule 501(a)(5) and (6) to permit "spousal equivalents" to pool their financial resources for the purpose of qualifying as accredited investors. Spousal equivalent will be defined as a cohabitant occupying a relationship generally equivalent to that of a spouse, in order to promote consistency with the SEC's existing rules, specifically the Investment Advisers Act of 1940, the Jumpstart Our Business Startups Act of 2012 and Regulation Crowdfunding. Also, the amendments codify a clarifying note to Rule 501(a)(8) which addresses equity ownership of entities. In

determining accredited investor status under Rule 501(a)(8), the amendments will allow one to look through various forms of equity ownership to natural persons. If those natural persons are themselves accredited investors, and if all other equity owners of the entity are accredited investors, the entity will be considered an accredited investor under Rule 501(a)(8). The amendments also address the inconsistency between the definition of accredited investor in Rule 215 and Rule 501(a). To remedy this inconsistency, the amendments replace the existing definition in Rule 215 with a cross reference to the newly expanded accredited investor definition in Rule 501(a).

While many believe these amendments represent an overdue step in the right direction and highlight the SEC's continued willingness to modernize its rules, many critics argue that the amendments do not go far enough. Even the SEC in the amendments noted they "do not expect that number of newly eligible individual accredited investors to be significant compared to the number of individual investors that currently are eligible to participate in private offerings, and [they] expect the amount of capital invested by such newly eligible individual investors to have minimal effects on the private offering market generally." Regardless of the tension surrounding these updates, once effective, issuers and investors should pay keen attention to these new rules as they consider seeking to raise funds through or invest in private securities transactions.
