

SEC Expands Accredited Investor and Qualified Institutional Buyer Definitions to Allow More Participants in Private Offerings

October 14, 2020

The U.S. Securities and Exchange Commission (the "SEC") recently amended the definition of "accredited investor" under the Securities Act of 1933 (the "Securities Act"). These amendments add new categories of natural persons and entities and make other modifications to the existing definition that essentially allow more investors to participate in private offerings.

The amendments are intended to identify sophisticated investors with sufficient knowledge and expertise to participate in investment opportunities that do not have the disclosure, procedural requirements, and investor protections, provided by registration under the Securities Act. The amendments are part of a broader effort to improve the exempt offering framework under the Securities Act to promote capital formation and expand investment opportunities while maintaining appropriate investor protections. The amendments add new categories of natural persons that may qualify as accredited investors based on certain professional credentials or their status as a private fund's "knowledgeable employee," expand the list of entities that may qualify as accredited investors, add entities owning \$5 million in investments, add family offices with at least \$5 million in assets under management and their family clients, and extend coverage to "spousal equivalents".

The SEC expanded the list of entities eligible for qualified institutional buyer status to be consistent with the amendments to the accredited investor definition, maintaining the \$100 million threshold for these entities to qualify for qualified institutional buyer status, so called "QIBs".

The final rule is effective December 8, 2020.

In 2019, registered offerings accounted for \$1.2 trillion (30.8%) of new capital, compared to approximately \$2.7 trillion (69.2%) that was raised through exempt offerings. Of this, the estimated amount of capital being raised in private offerings under Rule 506(b) and 506(c) of Regulation D was approximately \$1.56 trillion. The accredited investor definition is a central component of the Rule 506 private offerings and plays an important role in other exemptions and other federal and state securities law contexts. Qualifying as an accredited investor is significant because accredited investors may participate in investment opportunities that are generally not available to non-accredited investors.

I. Amendments to the Accredited Investor Definitions

The SEC amended the accredited investor definition to add the following new categories of natural persons and entities:

1. Natural Persons Holding Professional Certifications

Any natural person in good standing holding any of the following credentials will qualify as an accredited investor: the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative (Series 65).

2. Knowledgeable Employees of Private Funds

For a private fund offering, natural persons who are “knowledgeable employees” of a private fund issuing the securities will qualify as accredited investors for investments in the fund. A “knowledgeable employee” has the same definition as under Rule 3c-5(a)(4) under the Investment Company Act of 1940 (the “Investment Company Act”) which covers: (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 (i.e., who oversees the Fund’s investments, such as the manager) as defined in Rule 3c-5(a)(1) of the private fund; and (ii) an employee of the private fund or the manager of the private fund who participates in the investment activities of the private fund, other private funds, or investment companies the investment activities of which are managed by the manager of the private fund, provided that such employee has been performing such functions and duties for at least 12 months.

A knowledgeable employee’s accredited investor status is extended to his or her spouse for joint investments made by the knowledgeable employee and his or her spouse in a private fund.

3. Registered and Unregistered Investment Advisers

Any SEC registered or state registered investment adviser and any exempt reporting adviser under Section 203(l) or (m) of the Investment Advisers Act of 1940 in Rule 501(a)(1) have been added to the list of financial institutions in the definition of accredited investor in Rule 501(a)(1).

4. Rural Business Investment Companies

The SEC added rural business investment companies (“RBIC”) to the definition of accredited investor in Rule 501(a)(1).

5. Limited Liability Companies

Limited liability companies were added to the list of entities that qualify as accredited investors in Rule 501(a)(3) if they have total assets in excess of \$5 million and were not formed for the specific purpose of acquiring the securities being offered. This codifies a longstanding SEC position. Under Rule 501(a)(4) and Rule 501(f) managers of limited liability companies are included as accredited investors.^[1]

6. Catch-all for Other Entities Meeting an Investments-Owned Test

The SEC added a new catch-all category in the accredited investor definition for any entity owning “investments,” as is defined in Rule 2a51-1(b) under the Investment Company Act^[2], in excess of \$5 million that is not formed for the specific purpose of acquiring the securities being offered. This covers entities not already listed in Rule 501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), such as Indian tribes, labor unions, governmental bodies and entities organized under the laws of a foreign country, as well as those entity types that may be created in the future.

7. Family Offices

“Family offices,” as defined in Rule 202(a)(11)(G)-1 under the Advisers Act are added to the definition of accredited investors if they meet the following criteria: (i) have assets under management in excess of \$5,000,000, (ii) that are not formed for the specific purpose of acquiring the securities offered, and (iii) whose 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 (“Eligible Family Offices”).

“Family offices” are entities established by families to manage their assets, plan for their families’ financial future, and provide other services to family members. Family offices are excluded from regulation under the Advisers Act under certain conditions. Under Rule 202(a)(11)(G)-1, a family office generally is a company that has no clients other than “family clients.” “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.

8. Family Clients

Added to the definition of accredited investor are “family clients” (as defined in the family office rule, Rule 202(c)(ii)(G)-1) whose prospective investment in the issuer is directed by that Eligible Family Office. This change provides additional comfort to some family offices investing on behalf of family members who may not have technically qualified as accredited investors, even though the investment decision was being driven by a sophisticated family office with substantial assets.

9. Permitting Spousal Equivalents to Pool Finances for the Purposes of Qualifying as Accredited Investors

Natural persons may now include joint income from spousal equivalents when calculating joint income under Rule 501(a)(6), and to include spousal equivalents when determining net worth under Rule 501(a)(5). Spousal equivalents are defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.

a) Note to Rule 501(a)(5) The SEC added a note to Rule 501 to clarify that the calculation of “joint net worth” for purposes of Rule 501(a)(5) can be the aggregate net worth of an investor and his or her spouse or spousal equivalent and that the securities being purchased by an investor relying on the joint net worth test of Rule 501(a)(5) need not be purchased jointly.

b) Note to Rule 501(a)(8) Under Rule 501(a)(8), an entity qualifies as an accredited investor if all the equity owners of that entity are accredited investors. The SEC added a note to Rule 501(a)(8) to clarify that, in determining accredited investor status under Rule 501(a)(8), one may look through various forms of equity ownership to natural persons. Thus, if those natural persons are themselves accredited investors, and if all other equity owners of the entity are accredited investors, the entity would be an accredited investor under Rule 501(a)(8).

II. Amendments to the Qualified Institutional Buyer Definition

Rule 144A provides an exemption from registration under the Securities Act for resales of certain restricted securities to QIBs. Rule 144A(a)(1)(i) specifies the types of institutions that are eligible for qualified institutional buyer status if they meet the \$100 million in securities owned and invested threshold. The SEC expanded the list of entities that are qualified institutional buyers. The SEC added RBICs, limited liability companies, institutional accredited investors under Rule 501(a), and the catch-all category added to the accredited investor definition of an entity type not otherwise already included in 144A by adding a new paragraph (J) to Rule 144A(a)(1)(i) if they satisfy the \$100 million investment threshold. This includes Indian tribes, governmental bodies, and bank-maintained collective investment trusts.

Eligible purchasers under Rule 144A(a)(1)(i) include entities formed solely for the purpose of acquiring restricted securities under Rule 144A, if they satisfy the test for qualified institutional buyer status.

III. Conforming Amendments to Securities Act Rule 163B

In light of these rule changes, the SEC made generally conforming changes to Rule 163B regarding testing-the-waters, which now enable exempt testing-the-waters with entities such as governmental bodies under Rule 501(a)(9) and certain family offices and institutional family clients under Rules 501(a)(12) and (13).

IV. Additional Details and Notes

Natural Persons Holding Professional Certifications

In the future the SEC may designate additional credentials as qualifying for accredited investor status. The SEC will consider the following non-exclusive list of attributes in determining which professional certifications and designations or other credentials qualify a natural person for accredited investor status:

- 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;
- 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;
- 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
- 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 verified.

The professional certifications and designations and other credentials currently recognized by the SEC as satisfying the adopted criteria will be posted on the SEC's website. That the individual holds the certification or designation should also be made publicly available by the relevant self-regulatory organization or other industry body.[3]

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[1] Rule 501(a)(4) includes as an accredited investor any director, executive officer, or general partner of the issuer of the securities being offered or sold. The term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer." Managers of limited liability companies perform a policy making function for the issuer equivalent to that of an executive officer of a corporation under Rule 501(f).

[2] Investments under Rule 2a5-1(b) under the Investment Company Act includes securities, real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents. Rule 501(a)(4) and Rule 501(f) includes managers of limited liability companies. Rule 501(a)(4) includes as an accredited investor any director, executive office, or general partner of the issuer of the securities being offered or sold. The term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer." Managers of limited liability companies perform a policy making function for the issuer equivalent to that of an executive officer of a corporation under Rule 501(f). Therefore, Rule 501(a)(4) and Rule 501(f) includes manages of limited liability companies.

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