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Memorandum

SEC Proposes to Expand the Accredited Investor Definition

January 23, 2020

The Securities and Exchange Commission (the "**SEC**") recently proposed amendments (the "**Proposed Amendments**") to the "accredited investor" definition in Regulation D ("**Reg D**") under the Securities Act of 1933 (the "**Securities Act**").[1] This memorandum summarizes the proposal and highlights some key takeaways for private fund sponsors ("**Sponsors**").

The Proposed Amendments are 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. According to the SEC's proposing release (the "**Proposing Release**"), the Proposed Amendments are an initial step in the SEC's broader effort to consider ways to harmonize and improve the exempt offering framework under the federal securities laws.[2] The SEC will likely take additional steps to modify the exempt offering framework, which could further enhance access to capital for Sponsors.[3]

What Sponsors Need to Know

- Overall Effect: If adopted, the Proposed Amendments would modestly expand the pool of investors eligible to invest in private funds by adding new categories of accredited investors under Reg D (subject to the Investment Company Act and Advisers Act limitations described below). For example, the Proposed Amendments would add "knowledgeable employees" of a private fund to the accredited investor definition.

[1] Amending the "Accredited Investor" Definition, Release Nos. 33-10734; 34-87784; File No. S7-25-19 (Dec. 18, 2019). In addition to proposing amendments to Reg D, the SEC also proposed amendments to 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 proposed amendments to Rule 144A would 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 investment threshold in the QIB definition. The proposed amendments would 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] *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"). For a discussion of some key topics addressed in the concept release and related comment letters, *see* *Main Street Gained Valuable Access to Private Markets in 2019*, Rajib Chanda & Christopher Healey, *Law360* (Dec. 17, 2019).

[3] *See* 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."); *see also* SEC Semiannual Regulatory Agenda, 84 FR 71286 (Dec. 26, 2019) (noting that the SEC staff is "considering recommending that the Commission propose rule amendments to harmonize and streamline the Commission's rules for exempt offerings in order to enhance their clarity and ease of use" and that the SEC has set a target date of September 2020 to issue a Notice of Proposed Rulemaking for such a proposal).

- No Material Effect on 3(c)(7) Funds: The Proposed Amendments are not likely to result in a significant increase in 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 would remain largely unchanged,[4] and the vast majority of qualified purchasers already qualify as accredited investors under the current framework.
- Effect on Other Private Funds: The expansion of the accredited investor definition would modestly broaden the pool of potential third-party investors for other funds that conduct private offerings under Reg D, including Section 3(c)(1) funds. Sponsors are reminded that investors in such 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.[5]
- No Adjustments to Financial Thresholds: Notably, the SEC did not propose adjustments to the financial thresholds set forth in the accredited investor definition (*e.g.*, the $5 million "total assets" threshold that certain entities must exceed to qualify as accredited investors). These thresholds have not been adjusted for inflation since they were adopted in 1982 and some SEC critics have argued that they should be increased.
- Subscription Document Changes: Sponsors would need to update the accredited investor certifications in their fund subscription documents to reflect any changes to the accredited investor definition (as applicable).
- Comment Period: Comments to the proposal are due on March 16, 2020.

Proposed 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

[4] 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 proposed amendments to the QIB definition would indirectly affect the qualified purchaser definition. *See supra* note 1 (discussing the proposed amendments to the QIB definition). However, these changes are unlikely to meaningfully expand the qualified purchaser definition.

[5] 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.

only to accredited investors and up to 35 non-accredited investors who meet an investment sophistication standard.[6]

The current accredited investor definition, set forth in Rule 501(a) of Reg D, includes various categories of natural persons and entities. Broadly speaking, the definition covers (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.

OVERVIEW OF PROPOSED AMENDMENTS

The SEC has proposed to expand the accredited investor definition in Rule 501(a) of Reg D. Specifically, the definition would be amended to include:

1. natural persons who hold certain professional certifications or designations or other credentials;
2. "knowledgeable employees" of the issuer of the securities being offered or sold where the issuer is a private fund;
3. family offices with more than $5 million in assets under management and their family clients;
4. SEC- and state-registered investment advisers;
5. rural business investment companies; and
6. any entity with investments in excess of $5 million that was not formed for the specific purpose of investing in the securities offered.

The Proposed Amendments would also permit spousal equivalents to pool their finances for purposes of the income and net worth thresholds set forth in the accredited investor definition. In addition, the Proposed Amendments would codify certain SEC staff interpretive positions relating to the definition.

These proposed modifications to the accredited investor definition are discussed in more detail below.

NATURAL PERSONS WITH PROFESSIONAL CERTIFICATIONS AND DESIGNATIONS AND OTHER CREDENTIALS

The current 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

[6] 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." *See* 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.

of the two most recent years, or joint income with that person's spouse exceeding $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.[7] A natural person who fails to exceed these net worth and income thresholds generally does not qualify as an accredited investor, unless he or she is a director, executive officer,[8] or general partner of the issuer or of the issuer's general partner.

The Proposed Amendments would broaden the pool of natural persons who qualify as accredited investors. In particular, the amended accredited investor definition would 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 would consider a non-exclusive list of attributes, which would 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.[9]

The SEC preliminarily expects to designate Series 7, 65, and 82 licenses as qualifying an individual for accredited investor status by means of an order accompanying the final rule. To the extent the SEC were to designate other certifications, designations, or credentials as qualifying credentials in the future, such designations would be made by means of an order, though the SEC anticipates that it generally would provide public notice and an opportunity for public comment before the issuance of any such order. The SEC would post on its website a list of all certifications, designations, and credentials it has recognized as qualifying an individual for accredited investor status.

KNOWLEDGEABLE EMPLOYEES

The Proposed Amendments would 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,[10] with respect to the issuer of the

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

[8] 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 No-Action Letter (Feb. 6, 2014) (expanding the interpretation of the "knowledgeable employee" definition in Rule 3c-5).

[9] The non-exclusive list of attributes would include 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 made publicly available by the relevant self-regulatory organization or other industry body.

[10] 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,

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.

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 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,"[11] as defined in Section 2(a)(51) of the 1940 Act.[12] 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."

For a natural person to qualify as an accredited investor under the current definition, he or she must either (1) pass the net worth test or income test set forth in the definition or (2) be a director, executive officer, or general partner of the issuer or of the issuer's general partner. The situation could arise where a knowledgeable employee (within the meaning of Rule 3c-5) of a particular private fund, which is offered exclusively to accredited investors for Reg D compliance purposes, does not pass the net worth test or income test and is not a director, executive officer, or general partner of the fund or of the fund's general partner. The knowledgeable employee, in this situation, would not be an accredited investor under the current definition and would therefore be unable to invest in the private fund. By contrast, this knowledgeable employee would qualify as an accredited investor under the amended definition.

FAMILY OFFICES AND FAMILY CLIENTS

The Proposed Amendments would 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 that meets the aforementioned conditions also would qualify as an accredited investor.

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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.

[11] 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.

[12] 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.

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.[13] The SEC has received comments noting that there may be circumstances where family offices do not fall within the current accredited investor definition.[14] The SEC stated in the Proposing Release that it expects that all or most current family offices would qualify as accredited investors under the amended definition.

OTHER NEW CATEGORIES OF ACCREDITED INVESTORS

Registered Investment Advisers: The current definition enumerates specific types of institutional investors that qualify as accredited investors regardless of the total amount of assets they own. The Proposed Amendments would expand this list of institutional investors to include all SEC- and state-registered investment advisers. Such investment advisers would qualify as accredited investors based on their status alone.

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 Proposed Amendments would add RBICs to this list. As a result, all RBICs would qualify as accredited investors.

Catch-All Category for Entities Meeting an Investments-Owned Test: The Proposed Amendments would 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 Proposed Amendments would incorporate the definition of "investments" in Rule 2a51-1(b) under the 1940 Act.[15] This catch-all category is intended to capture all existing entity forms not already included in the current definition, such as Indian tribes, labor unions, governmental bodies and 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 current 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

[13] 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.

[14] *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").

[15] 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.

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 staff has 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.[16]

To resolve these uncertainties, the Proposed Amendments would introduce the term "spousal equivalent," which would be defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse." Under the amended definition, a natural person would 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.

CODIFYING SEC STAFF INTERPRETIVE POSITIONS

Joint Net Worth: As described above, under the current accredited investor definition, 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.[17] The Proposed Amendments would add a note to the definition that codifies this staff interpretation, though the proposed note would reference not only spouses but also spousal equivalents.

Limited Liability Companies: The current 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 does not explicitly reference limited liability companies, the SEC staff has taken the position that limited liability companies that satisfy the two conditions set forth in this category are eligible to qualify as accredited investors.[18] The Proposed Amendments would codify this SEC staff interpretation.[19]

Look Through Guidance: The current definition includes an entity in which all of the equity owners are accredited investors. The SEC staff has 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

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

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

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

[19] In the Proposing 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 pursuant to Rule 501(a)(4).

natural person owners to determine whether they are all accredited investors under the definition.[20] The Proposed Amendments would add a note to the definition that would codify this staff interpretation.

Conclusion

The Proposed 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 Proposed Amendments, if adopted, would have on their fundraising activities and consider sharing their views on the Proposed Amendments with the SEC. We stand ready to advise Sponsors with regard to any final amendments the SEC ultimately adopts.

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