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# SEC Proposes Changes to Accredited Investor Definition

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## Proposed Amendments Would Expand Persons and Categories of Entities that Qualify as Accredited Investors

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### SUMMARY

On December 18, 2019, the SEC issued a release proposing amendments to the definition of “accredited investor” in Rule 501(a) of Regulation D and other of the SEC’s rules that would expand the persons or entities able to participate in the private capital markets.<sup>1</sup> The proposed amendments are intended to update and improve the definition to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in private capital markets without the additional protections of registration under the Securities Act of 1933. Comments on the proposed changes are due 60 days after publication of the Release in the Federal Register.

### PROPOSED AMENDMENTS

#### New Categories of Natural Persons Who Qualify as Accredited Investors

Except in the case of directors, executive officers or general partners of an issuer,<sup>2</sup> the current accredited investor definition uses only the financial measures of income and net worth as proxies for a natural person’s financial sophistication. The SEC has proposed two new categories of natural persons that take into account other measures of financial sophistication, based on professional knowledge or experience.

#### 1. Professional Certifications and Designations and Other Credentials

Under the proposed rules, the SEC would from time to time designate, by order, professional certifications and designations or other credentials (collectively, “credentials”) that meet certain criteria as qualifying an individual for accredited investor status. The proposed amendment includes the following non-exclusive list of factors that the SEC would consider in its analysis of particular credentials:

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- the 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 the 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 credential is made publicly available by the relevant self-regulatory organization or other industry body.

Based on this non-exclusive list of factors, the SEC anticipates that Licensed General Securities Representative (Series 7), Licensed Investment Adviser Representative (Series 65) and Licensed Private Securities Offerings Representative (Series 82) would be included as qualifying credentials in an initial SEC order accompanying a final rule, if adopted. Notably, an individual holding a designated credential would not be required to practice in a field related to the credential in order to qualify as an accredited investor, so long as the individual maintains his or her status as a holder of that credential.

### **2. Knowledgeable Employees of Private Funds**

The proposed rules would also qualify “knowledgeable employees” of a private fund as accredited investors for purposes of investments in the fund. “Knowledgeable employee” is defined in Rule 3c-5(a)(4) of the Investment Company Act of 1940, and generally includes individuals who participate in the management of the private fund.<sup>3</sup> The SEC believes that by virtue of their position with the fund, these employees are likely to be financially sophisticated and capable of fending for themselves in evaluating their investments in the fund, and that permitting them to invest may better align their interests with those of other investors.

### **New Categories of Entities that Qualify as Accredited Investors**

The proposed rule changes would also expand the current list of enumerated categories of entities that qualify as accredited investors under Rule 501(a). The Release notes that the proposed additional categories of entities are intended to take into account the development of new entity types since the implementation of Regulation D, as well as entity types which are similar to, but not precisely the same as, those entities currently enumerated under Rule 501(a). Specifically, the following entities would qualify as accredited investors under the Release:

- SEC- or state-registered investment advisers;
- rural business investment companies, as defined in Section 384A of the Consolidated Farm and Rural Development Act;<sup>4</sup>
- limited liability companies with total assets in excess of \$5 million and that were not formed for the specific purpose of acquiring the securities being offered;<sup>5</sup>
- “family offices” or “family clients of family offices” with at least \$5 million in assets under management and that were not formed for the specific purpose of acquiring the securities being offered;<sup>6</sup> and

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- any other entity owning investments in excess of \$5 million and that was not formed for the specific purpose of acquiring the securities being offered.<sup>7</sup>

The Release notes that the final category above is intended to capture any other undesignated entity type (e.g., Indian Tribes) or any new corporate form that might come into existence and gain acceptance but is not within the existing scope of Rule 501(a).

### **Permitting Spousal Equivalents to Pool Finances for Qualification as Accredited Investors**

Under the current accredited investor definition, an individual, together with a “spouse,” may qualify as an accredited investor by surpassing either the \$300,000 joint income threshold or the \$1 million joint net worth threshold. The proposed rules would allow persons to include joint income from or the net worth of “spousal equivalents” in these threshold calculations, with spousal equivalent defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.

### **Amendments to the Definition of “Qualified Institutional Buyer” Under Rule 144A**

The proposed rule changes would expand the list of entities that are eligible for qualified institutional buyer status under Rule 144A. Specifically, to correspond to the changes proposed to the accredited investor definition, the proposed rules would include RBICs, limited liability companies and any other institutional accredited investor as defined in proposed Rule 501(a) to the types of entities eligible for QIB status if they own and invest on a discretionary basis \$100 million in securities.

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ENDNOTES

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- <sup>1</sup> For the full text of the proposed rules, see “SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments” (the “Release”), *available at* <https://www.sec.gov/news/press-release/2019-265>.
- <sup>2</sup> Rule 501(a)(4) also qualifies as an accredited investor any individual who is a director, executive officer or general partner of a general partner of the issuer.
- <sup>3</sup> Rule 3c-5(a)(4) under the Investment Company Act of 1940 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 of the private fund; and (ii) an employee of the private fund or an affiliated management person of the private fund (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, 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 of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.
- <sup>4</sup> Under Section 384A of the Consolidated Farm and Rural Development Act, a “rural business investment company” (“RBIC”) must be approved by the Secretary of Agriculture and enter into a participation agreement with the Secretary of Agriculture. To be eligible to participate as an RBIC, the company must be a newly formed for-profit entity or a newly formed for-profit subsidiary of such an entity, have a management team with experience in community development financing or relevant venture capital financing and invest in enterprises that will create wealth and job opportunities in rural areas, with an emphasis on smaller enterprises.
- <sup>5</sup> This proposed amendment with respect to limited liability companies would codify a long-standing SEC staff interpretation that limited liability companies that satisfy the other requirements of the accredited investor definition are eligible to qualify as accredited investors under Rule 501(a)(3).
- <sup>6</sup> For this purpose, “family office” and “family client” are as defined in Rule 202(a) under the Investment Advisers Act of 1940. Generally, family offices are established by wealthy families to manage their wealth, plan for their families’ financial future and provide other services to family members.
- The proposed definition would apply only to a family office that was not formed for the purpose of acquiring the securities offered, and whose purchase 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.
- <sup>7</sup> For this purpose, “investments” is as defined in Rule 2a51-1(b) under the Investment Company Act of 1940.

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