

SEC Expands List of Investors Who May Participate in Unregistered Offerings

I. Overview

On August 26, 2020, the Securities and Exchange Commission (the “SEC”) voted to adopt amendments (the “Final Amendments”)¹ to the “accredited investor” definition to “update and improve the definition to identify more effectively investors that have sufficient knowledge and expertise to participate in investment opportunities that do not have the rigorous disclosure and procedural requirements, and related investor protections, provided by registration under the Securities Act of 1933” (the “Securities Act”). The Final Amendments also expand the list of entities eligible to qualify as qualified institutional buyers (“QIBs”). The Final Amendments largely follow the amendments as proposed on December 2019 with some modifications, as further described below.²

II. Accredited Investor

The changes to the accredited investor definition are intended to provide an alternative to wealth to determine the financial sophistication of investors by looking at characteristics that demonstrate an ability to assess an investment opportunity, as further described below.³

a. Natural Persons

i. Certifications, Designations, and Other Credentials

The Final Amendments reflect the SEC’s view that certain professional certifications, designations, and other credentials provide a reliable indication of financial sophistication and that the current rules, by relying solely on financial thresholds when determining financial sophistication, are unnecessarily restrictive. As such, the Final Amendments provide that the SEC may designate qualifying professional certifications, designations, and other credentials by order, with such designation to be based upon consideration of all the facts pertaining to a particular certification, designation, or credential. Holders of the certifications, designations, and other credentials must be in good standing with respect to such certifications, designations, and other credentials, although they do not need to be practicing in an area related thereto. Such certifications, designations, and other credentials will be posted on the SEC’s website, and initially include General Securities Representative license (Series 7), Private Securities Offerings Representative license (Series 82), Licensed Investment Advisor Representative license (Series 65). For

¹ For the full text of the final rule and the related SEC release, see Securities and Exchange Commission, Amending the “Accredited Investor” Definition, SEC Release No. 33-10824; 34-89669; File No. S7-25-19, available at <https://www.sec.gov/rules/final/2020/33-10824.pdf> (August 26, 2020) [hereinafter, the “Adopting Release”]. Unless otherwise specified, all quoted statements in this memorandum are taken from the Adopting Release.

² For the full text of the proposing release, see Securities and Exchange Commission, Amending the “Accredited Investor” Definition, SEC Release No. 33-10734; 34-87784; File No. S7-25-19, available at <https://www.sec.gov/rules/proposed/2019/33-10734.pdf> (December 18, 2019) [hereinafter, the “Proposing Release”]. Our memorandum summarizing the proposed amendments is available [here](#).

³ In addition to the changes to the definition of accredited investors described in this memorandum, the SEC adopted the amendments proposed in the Proposing Release allowing natural persons to 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). In addition, the SEC adopted other miscellaneous amendments as previously proposed, including amendments to Rule 501(a)(8) of the Securities Act (clarifying that if (i) all natural persons who own an entity are accredited investors and (ii) all other owners of equity of the entity are also accredited investors, then the entity constitutes an accredited investor under Rule 501(a)(8)).

future additions to the list, the SEC will take into consideration whether a certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable. The Final Amendments also clarify that the SEC will provide notice and opportunity for public comment before issuing any final order with respect to any future designations of qualifying credentials. The SEC did not adopt the proposed amendment that would have permitted individuals to self-certify that they have the requisite financial sophistication to be an accredited investor.

ii. Knowledgeable Employees of Private Funds

The Final Amendments allow “knowledgeable employees” of a private fund to qualify as accredited investors for investments in the fund. The “knowledgeable employee” definition is the same in scope as provided in Rule 3c-5(a)(5), which includes, among others, “trustees 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 person of the fund that oversees the fund’s investments, as well as employees of the private fund or the affiliated 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 for at least 12 months.” The SEC explained that it is not amending the definition of accredited investor to include “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the “Investment Company Act”), as the knowledgeable employee and qualified purchasers standards are distinct and serve different regulatory purposes.

b. Entities

As contemplated in the Proposing Release, the Final Amendments bring new categories of entities under the definition of accredited investor, including (1) SEC- and state-registered investment advisers, (2) rural business investment companies, (3) limited liability companies with total assets in excess of \$5 million that were not formed for the specific purpose of acquiring the securities being offered, (4) any entity owning “investments” in excess \$5 million that is not formed for the specific purpose of acquiring the securities being offered, (5) family offices (as defined by the “family office rule” in Rule 202(a)(11)(G)-1 of the Investment Advisers Act of 1940) or family clients of a family office that meet the following requirements: at least \$5 million in assets under management, not formed for the specific purpose of acquiring the securities offered, and the prospective investment is directed by “a person who has such knowledge and experience in financial and business matters that such family office would be capable of evaluating the merits and risks of the prospective investment.” In addition, accredited investor status is extended not only to all SEC- and state-registered investment advisers, but also to exempt reporting advisers. For purposes of the preceding clause (4), to eliminate confusion, “investments” has the same meaning as the existing definition under Rule 2a51-1(b) of the Investment Company Act and includes, among other things, securities, real estate, commodity interests, physical commodities, non-security financial contracts, cash, and cash equivalents.

c. Amendments to Rule 163B

The Final Amendments also amend Rule 163B under the Securities Act, which was adopted in September 2019 to permit issuers to use test-the-waters communications with QIBs and institutional accredited investors. “Accredited investors” for purposes of Rule 163B is amended to include: (1) the catch-all category of entities not formed for the specific purpose of acquiring the securities offered that own investments in excess of \$5 million under Rule 501(a)(9) (described in clause (4) of the preceding paragraph), (2) family offices that qualify as an accredited investor under Rule 501(a)(12), and (3) family clients that qualify as an accredited investor under Rule 501(a)(13). The SEC believes that the expanded scope of entities deemed to have the requisite financial sophistication may increase the use of Rule 163B and may result in issuers more effectively gauging market interest in contemplated registered offerings.

d. Expansions Specifically Not Addressed by the Final Amendments

The SEC had sought comment on other topics related to the accredited investor definition, including whether the financial thresholds should be adjusted for inflation, whether geographic-specific financial thresholds should be included, and whether investors advised by a registered investment adviser or a registered broker-dealer should be included as accredited investors. After reviewing the comments received, the SEC declined to effect any of these expansions but stated it would consider these additional categories in the future.

III. Qualified Institutional Buyers

The Final Amendments adopted the previously proposed amendment to add certain new categories of entity types that meet the existing \$100 million threshold under the QIB definition.⁴ These entities include rural business investment companies, limited liability companies, and any other institutional accredited investor not already included in the definition. In addition, in order to avoid confusion with Rule 501(a), a note to Rule 144A(a)(1)(i)(J) has been added to clarify that the entity seeking QIB status may be formed for the purpose of acquiring the securities being offered.

IV. Conclusion

The SEC adopted the Final Amendments notwithstanding the dissenting views of Commissioners Allison Herren Lee and Caroline Crenshaw, who released a joint statement emphasizing that the amendments “fail to ensure that the accredited investor definition functions effectively to protect vulnerable investors, fail to acknowledge and analyze existing data revealing the risks these choices pose for investors, particularly seniors, and fail, once again, to address the lack of data regarding private markets more broadly.”⁵ The amendments will become effective 60 days following their publication in the Federal Register.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email authors Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; or Joseph E. Cho at 212.701.3589 or jcho@cahill.com; or email publications@cahill.com.

⁴ Rule 144A(a)(1)(i) defines “qualified institutional buyer” as “[a]ny of the following entities, acting for its own account or the accounts of other [QIBs], that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity” and then lists certain entity types that qualify as QIBs.

⁵ For the full text of the joint statement, see Securities and Exchange Commission, Joint Statement on the Failure to Modernize the Accredited Investor Definition (Commissioners Allison Herren Lee and Caroline Crenshaw), available at <https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26> (August 26, 2020).