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SEC Adopts Massive Changes to "Accredited Investor" Definition

by Anthony J. Zeoli

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It is official—the "accredited investor" definition, which has not changed significantly since its enactment almost 40 years ago, has been massively upgraded. On August 26, 2020 the Securities and Exchange Commission ("SEC") adopted its final rule which fundamentally changes and broadens the standards for qualifying as an "accredited investor." The final rule also makes corresponding changes to the "qualified institutional buyer" definition in Rule 144A. The following is a summary of some of the amendments included in the final rule.

Amendments to Individual Investor Standards

First, the final rule adds the following two new, non-monetary, categories:

1. any individual holding a Series 7, 65, or 82 license in good standing or who holds certain other educational or professional certifications later designated by the SEC; and

2. any individual qualifying as a "knowledgeable employee" (*as defined in 17 CFR § 270.3c-5*) of a particular a private fund, solely with respect to an investment in such private fund.

The first new category above is the most significant as it will allow the SEC flexibility to identify additional qualifying certifications/designations and related qualifications from time to time (*by order*). It also opens the possibility of creating some form of general "qualification" test for persons who would otherwise not meet the criteria to qualify. For clarity, the above new categories are independent of the individual's income or net worth. Put another way, a person who falls within one of these new categories would qualify as an "accredited investor" without the need to further meet the traditional earned income/net worth requirements.

In addition to the above, the final rule modifies the existing wealth standards as well by allowing an individual to include joint income and joint net worth from "spousal equivalents," even if not held jointly, in determining such individual's satisfaction of the respective minimums. The term "spousal equivalent," as defined in the final rule, includes "*a cohabitant occupying a relationship generally equivalent to that of a spouse.*" The intent of this amendment is to clarify the rules to provide consistent regulatory treatment among traditional marriages, same-sex marriages, civil unions, and domestic partnerships. It should also be noted that the SEC specifically chose NOT to upwardly adjust the current income/net worth benchmarks (*i.e. $200,000 income per year ($300,000 jointly)/$1,000,000 net worth*).

Amendments to Entity/Institutional Investors Standards

The final rule adds the following new categories of qualifying entities/institutional investors:

1. any entity registered as investment advisers pursuant to Section 203 of the Investment Advisers Act of 1940 (*15 U.S.C. 80b-3; as well as exempt reporting advisers under Sections 203(l) and 203(m) thereof*) or applicable state laws;

2. any entity qualifying as "Rural Business Investment Company" (*as defined in Section 384(A)(14) of the Consolidated Farm and Rural Development Act; 7 U.S.C. 2009cc*);

3. any limited liability company having total assets exceeding $5 million which was not formed for the purpose of acquiring the subject offered securities;[1]

4. any entity which is indirectly owned by another entity comprised of equity owners that are individuals who qualify as "accredited investors;"[2]

5. any entity (*including Native American tribes, labor unions, government bodies and funds) owning "investments" (as defined in 17 CFR 270.2a51-1(b)*) in excess of $5 million which is not formed for the purpose of acquiring the subject offered securities; and

6. any "family office" or "family client" (*each as defined in 17 CFR § 275.202(a)(11)(G)-1*): (a) having at least $5 million in assets under management; (b) which was not formed for the purpose of acquiring the subject offered securities; and (c) whose prospective investments are managed 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.*"

Amendments to Qualified Institutional Buyer Standards

To correspond to the changes made to the "accredited investor" definition, the final rule adds a new catch-all category to Rule 144A(a)(1)(i) for any entity (*including Native American tribes, labor unions, government bodies and funds*) which is not already covered under Rule 144A(a)(1)(i) and which owns "investments" (*as defined in 17 CFR 270.2a51-1(b)*) in excess of $5 million; provided they also satisfy the $100 million in securities owned and invested threshold of course.

Conclusion

The final rule amendments, which will automatically go into effect 60 days after they are published in the Federal Register, will materially change and improve the private capital markets as we know them. Once in effect the above changes will allow many previously excluded individuals and entities to participate in the private capital market. As a result we are truly on the precipice of witnessing a monumental mass opening of the private capital market.

If you have questions, please contact Anthony Zeoli.

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1 Note, this addition will be in the form of a modification to existing Rule 501(a)(3) to include limited liability companies rather than an entirely new section.

2 Note, this addition will be in the form of a note to existing Rule 501(a)(8) saying that in "*determining the accredited investor status of an entity under Rule 501(a)(8), one may look through various forms of equity ownership to natural persons.*"

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