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Analyzing the Potential Effect of the SEC's Recent Changes to the "Accredited Investor" Definition

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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 final amendments to the "accredited investor" definition which fundamentally change and broaden the qualification standards and increase access to investments in the private capital markets. These amendments are game changing and include both new, non-wealth based, categories for individuals as well as several new entity categories. Corresponding changes are also made to the "qualified institutional buyer" definition in Rule 144A.

Background

The "accredited investor" definition is one of the most important definitions in all of securities law. In particular, this definition is a central component in the use of several exemptions from registration under the Securities Act of 1933 (the "***Act***") and state securities law; most notably, Rule 506 of Regulation D of the Act (*17 CFR 230.506*). Put another way, qualifying as an "accredited investor" is important because whether a person/entity qualifies will determine whether they will be permitted to invest (*and in some cases how much they will be permitted to invest*) in private capital market investments (*i.e. investments in private companies and offerings by certain funds, not generally available to non-accredited investors*).[1]

The "accredited investor" qualification standards are most notably codified in Rule 501 of Regulation D of the Act (*17 CFR 230.501*). Simply speaking, under the current definition only individuals who have an annual income of at least $200,000 (*or $300,000 of joint income*) for the past two years, or who have a net worth of at least $1 million (*excluding the value of their primary residence*) would qualify as an "accredited investor." On the entity side, only entities which are entirely owned by individuals who each meet the foregoing test, trusts with assets over $5 million, and a limited number of other entities (*e.g. banks, insurance companies, certain benefit plans, etc.*) would qualify as an "accredited investor." The current definition has been the topic of much debate, particularly because they are entirely based on the premise that wealth (*i.e. a certain level of income, net worth, or assets*) is the only way to determine financial sophistication.

For some time the SEC has been considering ways to, in its own words, "*simplify, harmonize, and improve the exempt offering framework, thereby expanding investment opportunities while maintaining appropriate investor protections and promoting capital formation*." In particular, since June of 2019, the SEC has released a series of proposals/reports discussing potential amendments to the existing "accredited investor" definition and opening the same to public comment. Their efforts culminated on August 26, 2020 with the adoption and release of its final rule which significantly amends Rule 501.[2]

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1 For a more detailed discussion on the current "accredited investor" definition and its importance please see "*Accredited Investor, What It Means And Why It Matters*."

2 With corresponding and related amendments also being made to 17 CFR 230.144A ("Rule 144A"), 17 CFR 230.163B ("Rule 163B"), 17 CFR 230.215 ("Rule 215") if the Act and 1 and 17 CFR 240.15g-1 ("Rule 15g-1") under the Securities Exchange Act of 1934.

In the final release, SEC Chairman Jay Clayton is quoted as saying:

> *"Today's amendments are the product of years of effort by the Commission and its staff to consider and analyze approaches to revising the accredited investor definition, …For the first time, individuals will be permitted to participate in our private capital markets not only based on their income or net worth, but also based on established, clear measures of financial sophistication. I am also pleased that we have expanded and updated the list of entities, including tribal governments and other organizations, that may qualify to participate in certain private offerings."*

Amendments

Generally speaking, the amendments significantly broaden the current "accredited investor" definition by adding several new categories of qualifying natural persons and entities. These newer categories represent persons/entities the SEC believes do not need the additional protections afforded by registration under the Act because they have enough financial sophistication or expertise.

- Amendments to Individual Investor Standards

  The Commission premised the amendments on the notion that the traditional wealth based qualifiers (*i.e. net income/net worth*) present in the current definition should NOT be the only means for establishing financial sophistication to qualify as an "accredited investor." Put another way, they believe an individual should not have to be rich in order to qualify as an "accredited investor." As such the final rule expands the definition to include certain non-monetary based criteria where individuals, who have enough education and/or experience to understand what they are investing in and the risks involved with such investment, would be able participate in private offerings regardless of their current income or net worth.

  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 clarification, 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*). In support of that decision the SEC noted in the final rule the following (*among other things*):

  > *"[W]e continue to believe that it is not necessary or appropriate to modify the definition's financial thresholds at this time … In addition, we continue to believe that (1) at an individual level, removing investors from the current pool, particularly those who have participated, or are currently participating, in the private placement market would be inappropriate on various grounds, including the imposition of costs and principles of fairness more generally and (2) at a more general level,*

a significant reduction in the accredited investor pool through an increase in the definition's financial thresholds could have disruptive effects on certain aspects of the Regulation D market."

- Amendments to Entity/Institutional Investors Standards

  Like the above additional categories added for individuals, 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;[3]

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

  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

  As noted in the final rule, similar to the definition of "accredited investor," the definition of "qualified institutional buyer" (*sometimes referred to as a QIB*) in Rule 144A (17 CFR § 230.144A) of the Act is intended to "*identify a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions*." In particular, under Rule 144(a)(1)(i) an investor will be deemed a "qualified institutional buyer" if they meet the $100 million in securities owned and invested threshold and if they fall within one of the limited number of investor types identified in Rule 144A(a)(1)(i)(A) – (I) (*e.g. banks, insurance companies, certain benefit plans, etc.*).

  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.

What These Changes All Mean

The amendments made by the final rule materially broaden the existing "accredited investor" definition and, resultantly, significantly increase the potential pool of investors in exempt securities offerings; including Rule 506(b), Rule 506(c) and Rule 144 offerings and (*for purposes of determining the total amount a particular investor can invest in a given offering*) Reg CF and intrastate crowdfunding offerings.

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3 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.

4 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."

The modifications to the individual investor categories will be particularly significant to those entities engaging in, and those portals supporting, Reg CF and intrastate crowdfunding offerings as they open the doors to a large pool of new, previously unqualified, investors; such as younger persons who may otherwise be certified/experienced in financial matters but who otherwise would not meet the existing income/net worth standards. Looking only at FINRA certified individuals (*as the Series 7, 65, and 82 licenses are expected to be among the initial categories of qualifying certifications/designations*) the SEC estimates that there are approximately **691,041 FINRA registered individuals** with such as of December, 2018. While many of these individuals may already qualify under the existing income/net worth standards, it's easy to see how just allowing this one subset of FINRA certified individuals to automatically qualify could allow for a significant number of new potential investors, meaning more money available to companies seeking funds. Moreover, FINRA certified individuals are just one set of individuals the SEC could eventually deem as qualified under the new generalized approved certification/designation. In prior comments from the SEC (as discussed in the final rule) there has been much discussion about extending similar treatment to CPAs, attorneys, and certain financial intermediaries who have enough education and/or experience to understand what they are investing in and the related risks. Not to mention the fact that the amendments leave open the possibility of the SEC (*either directly or in conjunction with FINRA or similar organization*) putting forth a general qualification test to allow any individual to seek qualification. All in all, the new approved certification/designation category of individuals certainly and materially increases the pool of potential individual investors.

While the above discussed bump in the pool of individual investors is significant, the potential effect of the modifications to the entity categories is GAME CHANGING! Putting it into context, as noted in the final rule, there was roughly **$2.7 trillion in investment funds raised via private securities transactions in 2019**:

Table 4: Overview of amounts raised in the exempt market in 2019[347]

Exemption	Amounts Reported or Estimated as Raised in 2019
Rule 506(b) of Regulation D	$1,492 billion
Rule 506(c) of Regulation D	$66 billion
Regulation A: Tier 1	$0.044 billion
Regulation A: Tier 2	$0.998 billion
Rule 504 of Regulation D	$0.228 billion
Regulation Crowdfunding[348]	$0.062 billion
Other exempt offerings[349]	$1,167 billion

Looking at only the new "family office" category above, as noted by the SEC in the final rule it is estimated that there are an **estimated 10,489 family offices in the United States managing more than $1.4 trillion in assets**. Now many of these existing "family offices" (*and the investment entities utilized by them*) may already be able to qualify under the existing standards. However, "family offices" typically involve the investment of money on behalf of multiple generations of the subject family, some of which might be unable to meet the existing income/net worth standards. This in turn may cause a given "family offices" (*or the investment entities utilized by them*) to be unable to satisfy the current "accredited investor" standard, leaving them generally unable to engage in private funding transactions. The new "family office" category will alleviate the foregoing issue altogether and even if it opens the door to only a minor percentage of new "family office" investors, billions of dollars in previously untapped investor funds will be coming into the private securities market, which is huge!

The real game changer, however, is the new general category for entities holding more than $5 million in assets/investments. Under the current standards only certain entity types can qualify as "accredited investors" regardless of the amount of assets/investments. This has completely shut out many sophisticated, and deep-pocketed, investment entities from participating in the private securities market and has been a big topic of heavy debate over the last two decades.[5] Such excluded entities include, among others, Indian tribes, labor unions, sovereign wealth funds, 529 Educational Savings Plans, and governmental/quasi-governmental bodies. This means that the **trillions, maybe tens of trillions**, of investable dollars held by these entities are currently excluded from flowing into the private market, which is dumbfounding.

5 For a more detailed discussion, please see "Out of Alignment: The Dysfunctional Definition of an Accredited Investor & The Often Overlooked "Entity" Issue."

Take, for example, prosperous Indian tribes who, collectively, generated **$33.7 billion in revenues from the gaming industry in 2018 alone**.[6] Consider also labor unions who hold a significant percentage of the **estimated $107 billion in assets held by U.S. pension/benefit**[7] plans as of 2019. These new amendments open up the private securities markets to these two entity classes (among others) and new investments from these classes alone have the potential to double, if not triple, the total amount of investment funds raised via private securities transactions today. Not to mention the fact that these are only two of the numerous, previously excluded, entity classes which may now qualify under the amended standards. As such, the potential effect of just this one new general category, in terms of both new investor participation and the available pool of private investment capital, is truly monumental.

Conclusion

These amendments have been a long time coming and represent the culmination of years of heated debate. While there have been various bills and other legislation put forth over the years to accomplish one or more of the final rule amendments, none have succeeded until now. We are truly on the precipice of witnessing a mass opening of the private securities market. 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.

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6 See "*National Indian Gaming Commission – 2018 Indian Gaming Revenues*," available at https://www.nigc.gov/news/detail/2018-indian-gaming-revenues-of-33.7-billion-show-a-4.1-increase.

7 See "*US Department of Labor- 2019 Agency Financial Report*," at pg. 45, available at https://www.dol.gov/sites/dolgov/files/OPA/reports/2019annualreport.pdf.

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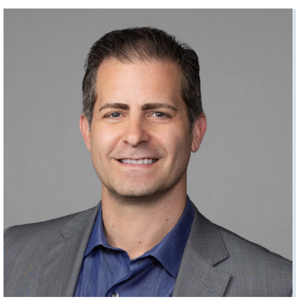

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