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SEC Proposes Expansion of the Definitions of "Accredited Investor" and "Qualified Institutional Buyer"

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At the Securities and Exchange Commission's (the "Commission") open meeting on December 18, 2019, the Commissioners approved proposed amendments to the definition of "accredited investor" under Regulation D under the United States Securities Act of 1933, as amended (the "U.S. Securities Act") and the definition of a "qualified institutional buyer" in Rule 144A under the U.S. Securities Act.

Commissioners Robert Jackson and Allison Lee both dissented on the proposal. The statements of the commissioners on the proposed rules showcased significant disagreement between them on the role of the Commission and the fundamental purposes of the federal securities laws. Commissioner Jackson's public statement was titled *Statement on Reducing Investor Protections around Private Markets* and highlighted his belief that the new release does not take the Commission's role in protecting investors seriously. Commissioner Lee also noted her concern regarding the one-sided nature of the proposed rules which seek to expand the pool of available investors without adequately considering an adjustment in the income and wealth thresholds.

The amendments to the definition of "accredited investor" are meant to provide more opportunity for main street investors to participate in private capital markets by including a greater number of institutional and individual investors that have the knowledge and expertise to participate in private capital markets. The proposed amendments add new categories of natural persons and entities that qualify as accredited investors. Specifically, the proposed amendments would:

- add new categories of natural persons that may qualify as accredited investors based on certain professional certifications or designations or other credentials or their status as a private fund's "knowledgeable employee;"
- expand the list of entities that may qualify as accredited investors and allow entities meeting an investments test to qualify;
- add family offices with at least $5 million in assets under management and their family clients; and

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- add the term “spousal equivalent” to the definition.

Changes are also proposed to the “qualified institutional buyer” definition to include limited liability companies, RBICs, and any institutional accredited investor not already listed in Rule 144A when they meet the existing threshold of $100 million in securities owned and invested.

Accredited Investor Definition

Current Definition

The definition of accredited investor is meant to identify sophisticated institutional and individual investors that are capable of participating in unregistered offerings of securities under the federal securities laws, including Rules 506(b) and 506(c) of Regulation D. Currently, the definition of accredited investor includes:

- A natural person that is a director, executive officer, or general partner of either the issuer of the securities or the general partner of the issuer of the securities;
- A natural person that, individually or jointly with such person’s spouse, has a net worth that exceeds $1 million (with certain exclusions) and that had income in excess of $200,000, or joint income with that person’s spouse in excess of $300,000, in each of the two most recent years, and has a reasonable expectation of reaching the same income level in the current year; and
- Certain entities, including banks, savings and loans associations, registered brokers or dealers, insurance companies, registered investment companies, business development companies (BDC), small business investment companies (SBIC), certain other entities (501(c)(3) organizations, trusts, and certain employee benefit plans) with total assets in excess of $5 million, certain other employee benefits plans, and any entity in which all of the equity owners are accredited investors.

New Natural Person Categories

The proposed amendments add two new categories in the “accredited investor” definition for natural persons (1) who hold certain professional certifications or designations or other credentials issued by an accredited educational institution, or (2) who are “knowledgeable employees” of a private fund and are investing in the private fund.

The adopting release sets forth certain criteria for qualifying certifications and designations that the Commission would designate by order from time to time. The adopting release identifies the Licensed General Securities Representative (Series 7), Licensed Investment Adviser Representative (Series 65), and Licensed Private Securities Offerings Representative (Series 82) as licenses initially to be designated.

The “knowledgeable employees” of a private fund who would qualify as accredited investors for investments in the fund would be the same employees as those defined in Rule 3c-5(a)(4) of the U.S. Securities Act. The definition would include, among other persons, 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.

Spousal Equivalent Addition

The proposed amendments add a note to Rule 501 to clarify that the calculation of "joint net worth" for purposes of Rule 501(a)(5) can be the aggregate net worth of an investor and his or her spouse (or spousal equivalent if "spousal equivalent" is included in Rule 501(a)(5), as proposed (see below)), and that the securities being purchased by an investor relying on the joint net worth test of Rule 501(a)(5) need not be purchased jointly.

The amendments also propose to permit natural persons to include joint income and joint net worth from spousal equivalents when determining income and net worth for purposes of qualifying as accredited investors. A "spousal equivalent" would mean a cohabitant occupying a relationship generally equivalent to that of a spouse (which the SEC previously described as including domestic partnerships, civil unions, and same-sex marriages), and assets would not need to be held jointly to be included in the calculation.

No Adjustment for Inflation for Natural Person Financial Thresholds

The SEC is not proposing to raise the current net worth or income financial thresholds or adjust them for inflation. This is likely to substantially increase the number of U.S. households that would qualify as accredited investors moving into the future.

Institutional Accredited Investors

The proposed amendments would add the following entities to those that qualify as accredited investors:

- Investment advisers registered under Section 203 of the Investment Advisers Act and investment advisers registered under the laws of the various states;
- Rural business investment companies ("RBIC"), which are defined in Section 384A of the Consolidated Farm and Rural Development Act as companies that are approved by the Secretary of Agriculture and that have entered into participation agreements with the Secretary;
- Limited liability companies that have total assets in excess of $5 million and were not formed for the specific purpose of acquiring the securities offered;
- A "catch-all" category for any entity, including Indian tribes, labor unions, government bodies and funds, and entities organized under the laws of a foreign country, owning "investments," as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered; and
- "Family offices" with at least $5 million in assets under management and their "family clients," as each term is defined under the Investment Advisers Act.

Look-Through Provisions

The proposed amendments would add a note to Rule 501(a)(8) that would clarify that, in determining accredited investor status under Rule 501(a)(8), one may look through various forms of equity ownership to natural persons. Thus, if those natural persons are themselves accredited investors, and if all other equity owners of the entity are accredited investors, the entity would be an accredited investor under Rule 501(a)(8).

Qualified Institutional Buyer Definition

The proposed amendments to the "qualified institutional buyer" definition under Rule 144A match those proposed to the "accredited investor" definition. The amendments would add RBICs and limited liability companies to the entity types that are eligible for qualified institutional buyer status if they meet the threshold of $100 million in securities owned and invested. Further, the proposed amendments would also add a "catch-all" category to allow an entity type that is not already included in the "qualified institutional buyer" definition, but that would qualify as an accredited investor, to be a qualified institutional buyer when such institutional investor satisfies the threshold of $100 million in securities owned and invested under Rule 144A.

The proposal will be open to public comment for 60 days upon its publication in the Federal Register. The full text of the proposal is available here.