SEC Amends Definition of "Accredited Investor" and Expands List of Entities Eligible to Qualify as "QIBs"

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On August 26, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to the definition of "accredited investor" under Rules 215 and 501(a) of the Securities Act of 1933, as amended (the "Securities Act") as well as amendments to the definition of "qualified institutional buyer" under Rules 144A and 163B of the Securities Act and Rule 15g-1 of the Securities Exchange Act of 1934 (the "Exchange Act"). These amendments were published in the Federal Register on October 9, 2020 (85 FR 64277), and become effective on December 8, 2020. The final rule can be found in the Federal Register and on the SEC's website.

Expansion of the "Accredited Investor" Definition

In an effort to promote capital formation while still ensuring adequate investor protection, the amended definition expands the categories of persons who are eligible to participate in private placements that do not have specific disclosure requirements. Previously, the accredited investor definition focused on investors meeting certain income or net worth thresholds. Now, in addition to the previous qualifications, the SEC has recognized that notwithstanding the financial thresholds, investors my qualify as accredited investors due to their ability to assess an investment opportunity.

The definition of accredited investor in Rule 501(a) now includes individuals holding certain professional certifications, as well as certain private fund employees, limited liability companies, investment advisers, and governmental entities. Securities Act Rule 215 and Exchange Act Rule 15g-1 are amended to replace the existing definition with a cross-reference to Rule 501(a). The new categories of accredited investors are as follows:

- Rule 501(a)(1) was amended to include all SEC- and state-registered investment advisers and exempt reporting advisers, as well as Rural Business Investment Companies ("RBIC") as defined in Section 384A of the Consolidated Farm and Rural Development Act.

- Rule 501(a)(3) was amended to include limited liability companies with total assets in excess of $5 million that are not formed for the specific purpose of acquiring the securities being offered.

- Rule 501(a)(9) was amended to include any entity owning investments[1] in excess of $5 million that is not formed for the specific purpose of acquiring the securities being offered.

[1] Defined in Rule 2a51-1(b) under the Investment Company Act of 1940 (the "Investment Company Act") to include securities, real estate, commodity interests, physical commodities, non-security financial contracts held for investment purposes, and cash or cash equivalents.

This category is intended to include Native American tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country.

- Rule 501(a)(10) was added to provide that accredited investors include natural persons holding certain licenses or certifications. By order, the SEC has designated persons holding the following licenses as accredited investors: the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative (Series 65). In addition, the SEC plans to designate additional certifications by separate order, which will be available for public comment. As of November 11, 2020, such order has not been issued.[2]

- Rule 501(a)(11) was added to provide that accredited investors include "Knowledgeable Employees of Private Funds." A "knowledgeable employee" is defined in Rule 3c-5(a)(4) of the Investment Company Act of 1940 to include trustees and advisory board members of a "private fund."[3] A "knowledgeable employee" also includes "an affiliated person of the fund that oversees the fund's investments," as well as employees of the private fund or the affiliated persons of the fund 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 term does not include employees performing solely clerical, secretarial, or administrative functions.[4]

- Rule 501(a)(12) was added to include family offices[5] that have more than $5 million in assets, that are not formed for the specific purpose of acquiring the securities offered, and whose prospective investments are 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 investments."

In addition, the SEC codified several staff interpretations of Rule 501 by adding the definition of "spousal equivalent" to mean a cohabitant occupying a relationship generally equivalent to that of a spouse, which is also included under the amended joint income test in Rule 501(a)(6). The SEC added the following notes to Rule 501:

- The calculation of "joint net worth" for purposes of the $1m net worth test can be the aggregate net worth of the investor and its spouse, or spousal equivalent;

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[2] In the adopting release, the SEC acknowledged that "there may be other professional certifications, designations, and credentials that indicate a similar level of sophistication in the areas of securities and investing," the SEC intended to take a "measured approach" in proceeding slowly.

[3] Section 202(a)(29) of the Investment Advisers Act of 1940 (the "Investment Advisers Act") defines a "private fund" as an issuer that would be an investment company as defined in Section 3 of the Investment Company Act but for the exemptions provided by Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act.

[4] The adopting release indicated that the category of "knowledgeable employees" was intended to be similar to the existing category for directors, executive officers, or general partners of the issuer in Rule 501(a)(4).

[5] Defined in the "family office rule," Rule 202(a)(11)(G)-1 under the Investment Advisers Act.

- The securities being purchased by an investor relying on the joint net worth test do not need to be purchased jointly; and

- When determining the accredited investor status of an entity in which all equity owners are accredited investors, one may look through various forms of equity ownership to natural persons.

Notably, in response to comments requesting an increase in the income and net worth thresholds for invidiuals due to inflation, the SEC stated that "we do not believe that this correlates to a lower level of financial sophistication."

As a result of the changes to Rule 501(a), the SEC also amended Rule 163B, which allows for "testing-the-waters" with qualified institutional buyers as defined under Rule 144A or institutions that are accredited investors as defined in Rule 501(a) to include the additional categories of institutional investors in Rule 501(a)(9) (entities owning $5 million or more in assets not formed for the specific purpose of investing in the offering), 501(a)(12) (family offices) and 501(a)(13) (covering family clients).

The SEC also revised Rule 15g-1(b), which requires brokers to disclose certain specified information to their customers prior to effecting "penny stock" transactions to exempt from such rule accredited investors that fall under the definitions in Rules 501(a)(9), (a)(12) and (a)(13).

Expansion of the "Qualified Insitutional Buyer" Definition

The SEC also expanded the definition of "qualified institutional buyer" (institutions having $100 million or more in securities owned and invested) in Rule 144A to include RBICs, limited liability companies, Native American tribes, governmental bodies, and bank-maintained investment trusts to parallel the same changes made to Rule 501(a). The SEC declined to add the family office and family client definitions to Rule 144A that are a part of the changes to Rule 501.