Alert

SEC Updates Accredited Investor and QIB Definitions

September 21, 2020

On Aug. 26, 2020, the SEC promulgated final rule amendments ("Final Rule")[1] that, among other things, broaden the definitions of "accredited investor" ("AI") in SEC Regulation D under the Securities Act of 1933 ("'33 Act") and "qualified institutional buyer" ("QIB") in SEC Rule 144A. The AI definition is key in determining who is eligible to participate, under the safe harbor contained in Rule 506 of Regulation D, in offerings of securities not subject to registration under the '33 Act. The exemption afforded by Regulation D is widely relied upon by private fund managers as well other types of issuers.

The Final Rule largely reflects the SEC's December 2019 proposal,[2] and is primarily a collection of gap-filling amendments. Nevertheless, these changes should be understood by all private fund managers that rely on Regulation D or who advise on transactions that require participants to make QIB representations, if only because these amendments likely will require changes to fund subscription documentation.

The Final Rule will be effective 60 days following its publication in the Federal Register (i.e., effective date likely to be prior to the end of 2020).

Accredited Investor Amendments

The Final Rule adds to SEC Rule 501(a) two new categories of natural person AIs and several new categories of qualifying entities. These represent a modest expansion of the types of investors that qualify as AIs.

New Natural Person AI Categories

- *Certain Professional Certificate Holders*. Amended Rule 501(a)(10) provides criteria by which the SEC may designate individuals who hold certain educational credentials in good standing as AIs, regardless of income level or personal assets. Under an order issued contemporaneously with the Final Rule,[3] the SEC has indicated that holders of FINRA Series 7 (Licensed General Securities Representative), Series 65 (Licensed Investment Adviser Representative) or Series 82 (Licensed Private Securities Offerings Representative) licenses will qualify as AIs.[4] Qualifying certificate holders are not required to practice in the fields related to their certification.
- *Knowledgeable Employees*. Rule 3c-5(a)(4) of the Investment Company Act of 1940 ("'40 Act") defines a set of "knowledgeable employees" — individuals intimately involved with an

[1] *See* SEC, Amending the "Accredited Investor" Definition, Release Nos. 33-10824; 34-89669, (Aug. 26, 2020), available here.

[2] *See* SEC Release Nos. 33-10734; 34-87784, (Dec. 18, 2019), available here.

[3] *See* SEC, Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status Pursuant to Rule 501(a)(10) under the Securities Act of 1933, Release No. 33-10823, (Aug. 26, 2020), available here.

[4] The SEC did not include the Series 3 exam, a proficiency certification generally required for salespersons of NFA-registered commodity pool operators and commodity trading advisors, although it remains open to considering additional qualifications in the future.

investment company's management or investment activities — as being eligible to invest in investment funds that are exempt from '40 Act registration without being "qualified purchasers." Under new Rule 501(a)(11), knowledgeable employees will now also qualify as accredited investors. The SEC has confirmed that a knowledgeable employee's spouse will also count as an AI with respect to a joint investment in a private fund.[5]

New Entity AI Categories

- *SEC and State-Registered Investment Advisers and Rural Business Development Companies — With No Financial Test*. The SEC's amendments to Rule 501(a)(1) add investment advisers registered with U.S. states or the SEC as AIs without regard to any financial test; Rural Business Investment Companies have been included on the same basis.

- *SEC Exempt Reporting Advisers — With No Financial Test*. In a modification to the proposed release, the SEC added Exempt Reporting Advisers as AIs under Rule 501(a)(1), without regard to financial status.

- *Limited Liability Companies Compliant with Rule 501(a)(3).* Formalizing prior guidance, amended Rule 501(a)(3) explicitly qualifies limited liability companies with total assets exceeding $5 million as AIs (provided that such company was not formed specifically for the purpose of investing in the issuer in question).

- *Entities with More than $5 Million in Investments Generally.* New Rule 506(a)(9) grants AI status to *any* entity of a type not covered in Rule 506(a)(1)-(3), (a)(7) or (a)(8) with more than $5 million in "investments"[6] (rather than assets), provided that it was not formed for the specific purpose of acquiring the securities of the issuer in question. The SEC views this new rule as providing a broad fallback for financially sophisticated entities that are not covered under other provisions of its AI definition, including types that the SEC has yet to specifically consider.

- *Family Offices and Their Clients.* The SEC's new Rule 501(a)(12) grants AI status to any "family office"[7] that (1) has over $5 million in assets under management; (2) is not formed for the specific purpose of acquiring the securities offered; and (3) has its prospective investment directed by a person who has such knowledge and expertise in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment. Additionally, new Rule 501(a)(13) provides that a "family client" of an office that satisfies the foregoing requirements will qualify as an AI with respect to an investment in an issuer, provided that family client's investment in the issuer is directed by its family office. The SEC emphasized that this category does not apply to "multi-family offices" (which are not covered by the family office rule).

[5] Note that the SEC did not state that this would include a "spousal equivalent" as incorporated in certain other amendments to the accredited investor definition; surrounding guidance suggests a literal construal of "spouse" in this context. *See* Final Rule, p.42, fn. 128.

[6] *See* SEC Rule 2a51-1(b) under the '40 Act.

[7] *See* SEC Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940.

Other Clarifying Amendments to the AI Definition

- *Spousal Equivalent.* The Final Rule includes coverage of "spousal equivalents" where certain provisions of the AI definition previously referred only to an individual's spouse. The Final Rule permits natural persons to include "spousal equivalents" when determining joint income or net worth under Rule 501 of Regulation D. New Rule 501(j) defines a "spousal equivalent" as being a "cohabitant occupying a relationship generally equivalent to that of a spouse."
- *Joint Net Worth Test.* Amendments to the accredited investor test in Rule 501(a)(5) clarify that the calculation of "joint net worth" may be the aggregate net worth of an investor and his or her spouse (or "spousal equivalent"). Furthermore, the securities being purchased in reliance upon this rule do not have to be purchased jointly.
- *Assets-Owned Entity Test.* Amendments to Rule 501(a)(8), which provides an AI qualification to entities entirely owned by AIs, clarify that in applying this test one may (*but is not required to*) look through any entity owners of the prospective AI to natural person equity owners. If such natural persons qualify as AIs (and all of the other equity owners of the entity are accredited investors) then the entity itself will share AI status.

Qualified Institutional Buyer Amendments

In parallel to its updates to the AI definition, the SEC has adopted conforming changes to various other rules. Most notably, the definition of "qualified institutional buyer" under Rule 144A has been amended to include any institutional AI as defined under Rule 501(a) (provided that such entities satisfy the $100 million in securities owned and invested test).

Implications for Private Fund Managers and Final Reflections

At a minimum, private fund managers should review the SEC's revised definitions to identify necessary updates to their subscription documents (such as the text of AI questionnaires) in light of the SEC's rule changes. We have revisions ready for our forms of subscription documents.

Private fund managers may also wish to consider the following practical points:

- *Implicit Support for 506(c) Offerings.* SEC Rule 506(c) permits unregistered offerings using general solicitations and general advertising, subject to the requirements that all participants be AIs and verification is undertaken to confirm AI status. The Final Rule highlights that certain of the new AI categories (e.g. for designated certificate holders and entities that meet its "catch all" $5-million investment test) are relatively easy to verify and may therefore help facilitate Rule 506(c) offerings.[8]
- *Assistance for Smaller Funds and Smaller Investment Vehicles*. The SEC's inclusion of knowledgeable employees as AIs may be significant for smaller private funds. Under SEC Rule 501(a)(8), funds with under $5 million in assets may themselves be AIs if all of their investors are, themselves, AIs. More generally, private fund managers who need to accommodate investments by family offices, entities advised by family offices and employees (and employee investment vehicles) may find the SEC's new AI categories useful. For example, the new definitions may assist in surmounting the non-qualification of certain family trust entities.

[8] *See* Final Rule, p. 113.

- *Knowledgeable Employees and AI Representations*. Knowledgeable employee status is typically determined by the private fund manager (not the employee). Fund subscription documents can provide space to indicate a manager's determination of an employee's status as a knowledgeable employee.
- *Professional Certificate Holders and AI Representations*. Managers making subscription agreement amendments to cover the new AI category for professional certificate holders can provide field for a prospective investor to indicate which of the relevant licenses they hold, and any additional information that would permit verification of good standing for that credential.

A few notable topics raised in the proposed amendments that clients may have been following were discussed in the SEC commentary accompanying the final amendments but not adopted:

- *QP and AI Remain Definitions Have Not Been Harmonized*. Despite some commenters' appeals, the SEC chose not to harmonize its accredited investor definition with the definition of a qualified purchaser — a similar, but separate, classification of sophisticated investors eligible to participate in exempt private funds under Section 3(c)(7) of the '40 Act. Accordingly, managers remain unable to treat QP and AI representations as interchangeable. The scenario of a qualified purchaser failing to also be an accredited investor applies to certain irrevocable trusts.
- *No Self-Certification for Investors*. The SEC previously solicited comments on whether individuals who do not otherwise qualify as AIs should be able to self-certify as to their level of investment sophistication to merit AI status. The SEC ultimately sided with commenters who believed such a provision would be too risky in light of a lack of standards and the effects of personal bias.
- *No "Catch All" Modification to Rule 501(a)(3)*. The SEC declined to modify its $5-million asset test in Rule 501(a)(3) to include all business entities similar to those enumerated, believing that its new Rule 506(a)(9) provides a sufficient fallback for new types of entities.
- *No Additional Coverage for Employees*. The SEC invited comments as to whether fund manager employees who do not quality as "knowledgeable employees" could qualify as accredited investors. Ultimately, the SEC decided not to expand the definition for reasons of statutory consistency and out of a view that the current knowledgeable employee definition generally captures individuals with the requisite sophistication to be AIs in view of their job responsibilities.
- *SEC Expansion of QIB Definition Limited to Alignment with AI Definition Updates*. The SEC received requests to expand Rule 144A to include various other persons beyond those added for to the new AI definition, including "family clients," private funds with $100 million in gross asset value and their investment advisers, clients of SEC-registered advisers that manage more than $100 million in securities, and clients of any SEC-registered investment advisers. However, the SEC choose not to act on these recommendations. Thus, the frustration for smaller credit funds and funds in their ramping up phase at being ineligible to purchase securities offered for resale pursuant to Rule 144A will continue.

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