

SEC modernizes the definition of accredited investor



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On August 26, 2020, the Securities and Exchange Commission (SEC) adopted amendments to the “accredited investor” definition, which is one of the principal tests for determining who is eligible to participate in private securities offerings. These changes are anticipated to become effective by the beginning of November (the final rule will be effective 60 days after publication in the Federal Register). The SEC stated that these amendments are intended to update and improve the existing definition of “accredited investor” to “identify more effectively investors that have sufficient knowledge and expertise to participate in investment opportunities.”

BACKGROUND

Because the “accredited investor” definition serves as a central element of multiple private offering exemptions under the Securities Act, including Rules 506(b) and 506(c) of Regulation D, the SEC has adopted this rule as a step in a broader effort to harmonize and improve the exempt offering framework. The goal is to identify more effectively potential investors that have sufficient knowledge and expertise to participate in private offerings and therefore do not need the additional protections of the Securities Act. Until last week, individuals that were “accredited investors” were defined solely based upon monetary measures: an individual with a net worth of more than \$1 million, either alone or together with a spouse (excluding the value of the person’s primary residence) or who has earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, were able to meet this

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threshold. Under the new rule, SEC Chairman Jay Clayton notes that, “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.”

NEW ACCREDITED INVESTOR DEFINITION

Under the final rule, the SEC’s updated Rule 501(a) added the following categories of accredited investors:

- individuals with certain professional certifications, such as a FINRA Series 7, 65 or 82 license;
- with respect to investments in private funds, individuals who are “knowledgeable employee[s]” of the funds (i.e., (i) executive officers, directors, trustees, general partner, advisory board members, or persons serving in a similar capacity of certain funds or affiliated persons of the fund that oversee the fund’s investments, and (ii) employees or affiliated persons of the fund (other than solely administrative employees) who have participated in the investment activities of such fund or substantially similar functions or duties on behalf of another company for at least 12 months);
- a “spousal equivalent” concept to the accredited investor definition, so that spousal equivalents (i.e., a cohabitant occupying a relationship generally equivalent to that of a spouse, such as a domestic partner or partner in a civil union) may pool their finances for the purpose of qualifying as accredited investors;
- certain limited liability companies with at least \$5 million in assets;
- SEC- and state-registered investment advisers, certain investment advisers exempt from registration, and rural business investment companies;
- any entity, including Indian tribes, owning certain “investments” 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).

PUBLIC POLICY AND THE FUTURE

The definition of “accredited investor” had not been updated in more than 35 years and these amendments dramatically broaden who is able to invest in private capital markets. This shows a growing shift in public policy from using wealth as the sole metric of determining investor sophistication and recognizing that other factors may provide individuals and entities with a level of sophistication in order to evaluate private investments. However, there are SEC officials who caution that even experienced investors face difficulties in identifying problems with private investments and worry that the definitional expansion is problematic. Commissioners Allison Lee and Caroline Crenshaw, who voted against the changes, said in a joint statement: “the commission continues a steady expansion of the private market, affording issuers of unregistered securities access to more and more investors without due regard for the risks they face, and without sufficient data or analysis to ensure that our policy choices are grounded in fact rather than supposition.”

Nevertheless, SEC Commissioner Elad L. Roisman supported the amendments “because they are our first steps away from the current, single criterion wealth-based system of eligibility.” Commissioner Roisman stated that he “would have supported venturing further down this path of expanding the definition to include knowledge-based eligibility” and he encourages the public to reach out regarding other categories that the SEC should consider adding to the definition of accredited investors. As such, we may see further expansion to the definition of “accredited investors” in the future despite cautionary analysis from those

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commissioners who voted against the amendments.

If you have any questions regarding the contents of this post, please feel free to reach out to one of the attorneys listed below.



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