

Clients & Friends Memo

SEC Adopts Rule Amendments Designed to Expand Access to Private Investment Opportunities

August 27, 2020

On August 26, by a 3-2 vote, the Securities and Exchange Commission (the “**SEC**”) adopted rule changes¹ that generally expand the scope of the definitions of “accredited investor” in Rule 501(a) of Regulation D and of “qualified institutional buyer” in Rule 144A under the Securities Act of 1933 (the “**Securities Act**”).² The SEC also adopted related changes to Rules 215 and 163B under the Securities Act and to Rule 15g-1 under the Securities Exchange Act of 1934 (the “**Exchange Act**”). The expanded definitions and other rule changes (the “**Amendments**”) will increase the number of investors that have access to private investment opportunities.³

I. Overview of the Amendments

- **Broadened Definition of “Accredited Investor.”** The amendments to the definition of “accredited investor” create new opportunities for both natural persons and entities to qualify under Rule 501 by:
 - i. creating a category for an individual currently holding certain professional certifications, designations or other credentials approved by the SEC, including FINRA Series 7, 65 or 82 licenses;
 - ii. permitting a “knowledgeable employee” of a private fund or of an investment adviser to the fund, or such person’s spouse, to qualify as an accredited investor for offerings of that fund’s securities;
 - iii. expanding the categories of institutional accredited investors to include limited liability companies with assets in excess of \$5 million, registered investment advisers, exempt reporting advisers and rural business investment companies (“**RBICs**”);
 - iv. creating categories of accredited investors for “family offices” with at least \$5 million in assets under management (“**AUM**”) and their “family clients,” as each term is defined under the Investment Advisers Act of 1940 (the “**Advisers Act**”);

¹ Amending the “Accredited Investor” Definition, Release Nos. 33-10824; 34-89669 (Aug. 26, 2020), *available at* <https://www.sec.gov/rules/final/2020/33-10824.pdf> (the “**Release**”). The Release incorporates, largely as proposed, amendments originally proposed by the SEC on December 18, 2019. *See* Amending the “Accredited Investor” Definition, 85 FR 2574 (Jan. 15, 2020), *available at* <https://www.govinfo.gov/content/pkg/FR-2020-01-15/pdf/2019-28304.pdf> (the “**Proposing Release**”).

² Unless otherwise noted, any references to Rules in this memorandum are to Rules under the Securities Act.

³ These changes are motivated, at least in part, by Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which directs the SEC to review the definition of “accredited investor” as it relates to natural persons at least once every four years. *See* Proposing Release at 2575-76. That said, Dodd-Frank of course materially increased regulation, while the Amendments are essentially deregulatory.

- v. permitting couples in a “spousal equivalent” relationship to qualify as accredited investors by pooling their finances;
 - vi. creating a “**catch-all**” category of institutional accredited investors for any entity, including any Indian tribe or governmental body, provided that the entity owns investments valued in excess of \$5 million and was not formed for the specific purpose of investing in the securities offered; and
 - vii. clarifying that an entity may qualify as an accredited investor on the basis that all of the entity’s equity is owned directly or indirectly by accredited investors.
- **Corresponding Amendments to Other Rules.** Rules 215 and 163B under the Securities Act and Rule 15g-1 under the Exchange Act have correspondingly been amended to include the new categories of accredited investors.
 - **Broadened Definition of “Qualified Institutional Buyer.”** The amendments to the definition of “qualified institutional buyer”:
 - i. expand the types of entities eligible for qualified institutional buyer status by including certain RBICs and limited liability companies that own and invest in at least \$100 million in securities of unaffiliated issuers; and
 - ii. permit an entity that qualifies as an institutional accredited investor under the “catch-all” category above to qualify as a qualified institutional buyer if it satisfies the \$100 million investment threshold.

II. Broadened Definition of “Accredited Investor”

The SEC’s amendments to the definition of accredited investor are largely driven by a determination to move away from the rule’s historic use of wealth and income as the sole proxies for financial sophistication.⁴ The SEC stated that the amendments to the definition of “accredited investor” “permit investors with reliable alternative indicators of financial sophistication to participate” in investments in “areas of the economy that disproportionately create new jobs, foster innovation, and provide for growth opportunities.”⁵

A. Natural Persons

- **Credentialed Investors.** In connection with the Amendments, the SEC issued a separate order designating that individuals holding FINRA Series 7 (General Securities Representative), Series 65 (Investment Adviser Representative), or Series 82 (Private Securities Offerings Representative) licenses in good standing qualify as accredited investors.⁶ To provide the SEC with regulatory flexibility, the Amendments give the SEC authority to issue, after providing opportunity for public comment, subsequent orders designating certain other qualifying credential holders as accredited investors.⁷ Such credential must have the following characteristics:
 - i. “The certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution;

⁴ See Release at 6, 26.

⁵ See *id.* at 5-6.

⁶ See Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status Pursuant to Rule 501(a)(1) under the Securities Act of 1933, Release No. 33-10823 (Aug. 26, 2020), *available at* <https://www.sec.gov/rules/other/2020/33-10823.pdf>. While the proposed rule did not contain a “good standing” requirement, the SEC adopted this as part of the Amendments at the suggestion of multiple commenters. See *id.* at 28. However, the SEC declined to require that an individual actually practice in the fields related to their certification in order to qualify as an “accredited investor”. See *id.*

⁷ See *id.* at 28, 33-34.

- ii. The examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;
 - iii. Persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and
 - iv. An indication that an individual holds the certification or designation is made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.”⁸
- **Knowledgeable Employees of Private Funds.** As proposed, the Amendments create a category of accredited investor for a private fund's “knowledgeable employees,” as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940 (the “**Company Act**”).⁹ The category is similar to the existing category of directors, executive officers, and general partners of the issuer or of a general partner of the issuer who qualify as “accredited investors” under Rule 501(a)(4).¹⁰ Additionally, the new category includes knowledgeable employees of a fund's investment adviser.¹¹

The Release additionally affirmed the SEC's continuing support for staff guidance that allows the spouse of a knowledgeable employee to make co-investments into the private fund jointly with his or her knowledgeable employee spouse.¹²

- **Family Clients of Family Offices.** The Amendments provide that “family clients” (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act) of family offices meeting the requirements described in Section II.B. below qualify as accredited investors.¹³ This eliminates the inconsistency wherein a family client may be considered a qualified purchaser under the Company Act but not an accredited investor.¹⁴
- **Individuals Jointly with Their Spouses or Spousal Equivalents.** Under Rules 501(a)(5) and 501(a)(6), an individual may qualify as an accredited investor if the individual, together with his or her spouse, has a joint annual income over \$300,000 or a joint net worth over \$1 million. The SEC adopted as proposed amendments that allow an individual to qualify by aggregating income or net worth with a “spousal equivalent,” defined as “a cohabitant occupying a relationship generally equivalent to that of a spouse.”¹⁵

⁸ Rule 230.501(a)(10).

⁹ For purposes of this category, a “private fund” is defined as a fund excluded from the definition of “investment company” in Section 3(c)(1) or 3(c)(7) of the Company Act. *See* Rule 250.501(a)(11).

¹⁰ *See* Release at 38-39 nn.122-23 and accompanying text.

¹¹ *See* Company Act Rules 3c-5(a)(1) and 3c-5(a)(4).

¹² In American Bar Association Section of Business Law, SEC Staff No-Action Letter (Apr. 22, 1999), staff did not recommend enforcement action against spouses making such joint investments, citing the belief that Congress intended to apply the Company Act's “spousal joint interest” position to Rule 3c-5. Company Act Section 2(a)(51)(A)(i) permits a spouse who is not a qualified purchaser to hold a joint interest in a Section 3(c)(7) fund with their spouse who is a qualified purchaser. *See* Release at 41-42 nn.127-28 and accompanying text.

¹³ *See* Section II.B. *infra.*; Release at 61.

¹⁴ *See* Proposing Release at 2590.

¹⁵ *See* Rule 230.501(j). While this definition is intended to be broad so as not to “distinguish between different types of relationships structures,” it would seem to include “persons in legally recognized unions, such as domestic partnerships, civil unions, and same-sex marriages.” *See* Proposing Release at 2590 nn.181-85 and accompanying text. *See also* Report on the Review of the Definition of “Accredited Investor” (Dec. 18, 2015), *available at* <https://www.sec.gov/corpfm/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf> (recognizing uncertainty as to “whether persons in legally recognized unions such as domestic partnerships, civil unions and same-sex marriages were considered spouses for purposes of the accredited investor definition,” and proposing that the SEC either define “spouse” in Rule 501 under Regulation D to include the foregoing persons or adopt the definition of “spousal equivalent” as used in Rule 202(a)(11)(G)-1(d)(9) applicable to family offices).

The SEC also added a note to Rule 501(a)(5) to clarify that an individual may rely on the “joint net worth” test to qualify as an accredited investor, regardless of whether the individual is purchasing the securities individually or jointly with his or her spouse (or spousal equivalent).¹⁶

B. Qualifying Entities

- **Registered Investment Advisers (“RIAs”).** The SEC expanded the definition of “accredited investor” to include any investment adviser registered with the SEC or under the laws of the various states, as RIAs have “the requisite financial sophistication needed to conduct meaningful investment analysis.”¹⁷ The Amendments also provide that venture capital fund advisers and small private fund advisers exempt from SEC registration under Sections 203(l) or 203(m) of the Advisers Act (so-called “exempt reporting advisers”) qualify as accredited investors under the expanded definition.¹⁸
- **RBICs.** The SEC determined that RBICs, as defined in Section 384A of the Consolidated Farm and Rural Development Act, should qualify as accredited investors because (i) they have a similar purpose to small business investment companies (“SBICs”), (ii) they are treated similarly to SBICs under the Advisers Act, and (iii) SBICs are already accredited investors under Rule 501(a)(1).¹⁹
- **Limited Liability Companies.** Noting that limited liability companies “have become a widely adopted corporate form,” the SEC codified, as proposed, longstanding staff guidance that a limited liability company may qualify as an accredited investor if it satisfies the definition’s other requirements.²⁰ Under the Amendments, a limited liability company that was formed specifically to acquire securities offered does not qualify as an accredited investor under Rule 501(a)(3), but such entity would qualify under Rule 501(a)(8) if all of the limited liability company’s equity owners were accredited investors.²¹ The Release also notes that under the Amendments, managers of a limited liability company qualify as accredited investors under Rule 501(a)(4) by virtue of their status as “executive officers” of an issuer.²²
- **Catch-All Category for Entities Owning \$5M in Investments.** The SEC adopted as proposed a “catch-all” category that qualifies any entity that is not specifically listed in the “accredited investor” definition if such entity (i) has “investments” (as defined in Rule 2a51-1(b) under the Company Act) in excess of \$5 million, and (ii) was not formed for the specific purpose of investing in the securities offered.²³
- **Family Offices.** The SEC adopted, substantially as proposed, a new category of accredited investor for any “family office” (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act): (i) having over \$5 million AUM; (ii) of which the investment decisions 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

¹⁶ It is unclear why the note to Rule 501(a)(5) relates only the “joint net worth” test, as the clarification seems equally relevant to the “joint income” test. *See* Release at 66-67; Proposing Release at 2585 n.121 and accompanying text (recognizing that the way in which an investor takes title to securities or how spouses own assets may be a matter of preference); Rule 501(a)(5). *See also* question number 255.11 of Securities Act Rules Compliance and Disclosure Interpretations, *available at* <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

¹⁷ *See* Release at 44.

¹⁸ *See id.* at 44-45.

¹⁹ *See id.* at 47.

²⁰ *See id.* at 48.

²¹ *See id.* at n.145 and accompanying text.

²² *See* Release at 50.

²³ The SEC chose an investments test over the assets test currently used for other categories of accredited investors (*e.g.*, for employee benefit plans under Rule 501(a)(1) and trusts under Rule 501(a)(7)). The SEC reasoned that if an assets test were used for the catch-all category of institutional investors, these miscellaneous entities may qualify by virtue of holding “\$5 million in non-financial assets such as land, buildings, and vehicles, *but not have any investment experience* [emphasis added].” By contrast, “an investments test may be more likely than an assets-based test to serve as a reliable method for ascertaining whether an entity is likely to require the protections of Securities Act registration.” *See id.* at 56.

risks of the prospective investment; and (iii) that is not formed for the specific purpose of acquiring the securities offered.²⁴

- **Entities in Which All Equity Owners Are Accredited Investors.** Under Rule 501(a)(8), an entity qualifies for accredited investor status if all of the entity's equity owners are accredited investors. The SEC adopted, as proposed, a note to Rule 501(a)(8) in line with existing SEC guidance clarifying that such equity ownership may be direct or indirect.²⁵

III. Related Amendments to Other Rules

A. Rule 215

Prior to the adoption of the Amendments, the definition of "accredited investor" in Rule 215 was not entirely consistent with the definition under Rule 501(a), as Rule 215 omitted banks, insurance companies, registered investment companies, and business development companies from its scope. The SEC adopted as proposed an amendment to Rule 215 that harmonizes the definition of "accredited investor" with the amendments to Rule 501(a) by replacing the former definition with a cross-reference to Rule 501(a).²⁶ The amendment also replaces Rule 215's prior strict liability standard in favor of Rule 501(a)'s requirement that an issuer must reasonably believe that a natural person or entity is an accredited investor.²⁷

B. Rule 163B

Rule 163B provides that issuers may engage in communications to institutional accredited investors and qualified institutional buyers to "test the waters" in registered offerings under the Securities Act. The Amendments expand the prior reference to Rule 501 to include the newly eligible categories of accredited investor under Rules 501(a)(9), (12) and (13).²⁸

C. Exchange Act Rule 15g-1

Exchange Act Rules 15g-2 through 15g-6 require broker-dealers to make certain disclosures to customers before engaging in "penny stock" transactions (as defined in Rule 4a51-1 under the Exchange Act). Rule 15g-1 exempts broker-dealers from this requirement in transactions in which the customer is an institutional accredited investor. The Amendments expand the prior reference to Rule 501 to include the newly eligible categories of accredited investor.²⁹

IV. Broadened Definition of "Qualified Institutional Buyer"

Rule 144A provides an exemption from the registration requirements of the Securities Act for resales of certain securities to qualified institutional buyers. In order to be eligible for qualified institutional buyer status, an institution must (i) be one of the types of institutions specified in Rule 144A(a)(1), and (ii) own and invest over \$100 million in securities of unaffiliated issuers.³⁰ The amendments to the definition of "qualified institutional

²⁴ See *id.* at 60-63.

²⁵ See *id.* at 67-68; Proposing Release at 2589.

²⁶ This significantly expands the applicability of Section 4(a)(5), which exempts issuers from registration for the offer and sale of securities to accredited investors in offerings under \$5 million in which the issuer does not engage in general solicitation or general advertising. See Release at 69 n.222 and accompanying text.

²⁷ See Release at 70.

²⁸ See *id.* at 83-84.

²⁹ See *id.* at 85-86.

³⁰ SEC-registered securities dealers are subject to a lower threshold, though this is not relevant to the Amendments.

buyer” expand the list of qualifying institutions, corresponding directly to the amendments to the definition of “accredited investor” so as to eliminate anomalies between types of entities qualifying under either standard.³¹

- **RBICs and Limited Liability Companies.** The SEC amended Rules 144A(a)(1)(i)(C) and 144A(a)(1)(i)(H) to add RBICs and limited liability companies to the list of entities that qualify for qualified institutional buyer status if they meet the \$100 million threshold.³²
- **Institutional Accredited Investors Meeting the \$100M Threshold.** Any entity that does not fall within one of the existing categories of qualified institutional buyer is now permitted to qualify under Rule 144(A)(a)(1)(i)(J) if it (i) is an institutional accredited investor, and (ii) meets the \$100 million threshold. This category encompasses entities such as Indian tribes, governmental bodies and bank-maintained collective investment trusts.³³

V. Summary and Policy Considerations

The Amendments to the “accredited investor” and “qualified institutional buyer” definitions are consistent with the agenda of the SEC under Chair Jay Clayton to promote capital formation and expand investment opportunities in the U.S. financial markets. The Amendments which impact Regulation D issuers (*e.g.*, private funds) and their investors, add new categories to the definitions, including catch-all categories that promote regulatory flexibility.

Interestingly, the SEC did not originally propose—nor did it adopt amendments—to any of the financial thresholds in the current definition of “accredited investor” (*i.e.*, \$1 million net worth or \$200,000 annual income for individuals and \$300,000 annual income for couples, or for entities, \$5 million in assets for entities), in effect generally since 1982. In the Proposing Release, the SEC stated that any financial threshold changes would be disruptive to the Regulation D markets but nonetheless requested comment on this decision.³⁴ The SEC provided a variety of reasons for leaving the financial thresholds intact,³⁵ although this decision is controversial and was criticized by the dissenting Commissioners.

A. The Commissioners’ Statements

- **Chairman Clayton.** Characterizing the Amendments as “modest, incremental” changes, the Chairman cited “broad, almost universal support for” the SEC’s efforts to modernize the securities laws. Chairman Clayton asserted that “women, minority and other underrepresented entrepreneurs” were paramount among those that the Amendments would serve as they often “struggle to access capital,” and stated that the SEC’s “Small Business Capital Formation Advisory Committee continues to explore how we might better serve these important segments of our markets.” Additionally, the Chairman stated his belief that raising the financial thresholds would be “inappropriate” and “unworkable” because it would take eligibility away from some investors who currently invest in private funds.³⁶
- **Commissioner Roisman.** Commissioner Roisman similarly expressed support for the expansion of the “accredited investor” definition to include credentialed investors, stating that the prior rule’s emphasis on wealth and income as sole proxies for financial sophistication was “fundamentally unfair, unequal, and unjustified.” He additionally signaled his support for “venturing further down this path of expanding the

³¹ See Proposing Release at 2597-98.

³² See Release at 87-88; see also Section II.B. *supra*.

³³ See Release at 87-88, 91. Additionally, the Amendments incorporate a note to clarify that an entity may still qualify for qualified institutional buyer status under Rule 144(A)(a)(1)(i)(J) if the entity was formed solely for the purpose of acquiring the securities being offered, unlike the corresponding “catch-all” category of accredited investor in Rule 501. See *id.* at 93.

³⁴ See Proposing Release at 2592-96 (discussing the merits of raising the financial thresholds, and various alternatives including indexing financial thresholds going forward, or making a one-time adjustment to the current levels).

³⁵ See Release at 70-77.

³⁶ See Statement on Modernization of the Accredited Investor Definition (Aug. 26, 2020), available at <https://www.sec.gov/news/public-statement/clayton-accredited-investor-2020-08-26>.

definition to include knowledge-based eligibility,” and suggested that the monetary thresholds should be done away with altogether.³⁷

- **Commissioner Peirce.** Echoing Chairman Clayton’s and Commissioner Roisman’s sentiments that the Amendments do not go far enough to expand the definition of “accredited investor,” Commissioner Peirce suggested a variety of alternatives to remove the responsibility for determining who is a “sophisticated” enough investor from the SEC and embolden investors to make their own decisions.³⁸
- **Commissioners Lee and Crenshaw.** In a joint statement, Commissioners Lee and Crenshaw decried the Amendments as “counter to widespread support for” indexing the financial thresholds to inflation, citing that such failure has led to “an increase of 550% in qualifying households” since the rule’s adoption. The dissenting Commissioners also asserted that the SEC lacks sufficient evidence into “how the private market functions” to determine what “vulnerable investors,” including seniors, may be at risk of fraud or substantial loss from the expanded definition of “accredited investor.”³⁹

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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³⁷ See Commissioner Roisman Statement on Amending the “Accredited Investor” Definition (Aug. 26, 2020), available at <https://www.sec.gov/news/public-statement/roisman-statement-amendments-accredited-investor-definition>.

³⁸ See Statement on Amending the “Accredited Investor” Definition (Aug. 26, 2020), available at <https://www.sec.gov/news/public-statement/peirce-accredited-investor-2020-08-26>.

³⁹ See Joint Statement on the Failure to Modernize the Accredited Investor Definition (Aug. 26, 2020), available at <https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26>.