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SEC Expands the “Accredited Investor” and “QIB” Definitions and the Permitted Scope of “Testing the Waters”

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The Securities and Exchange Commission ("SEC") has approved amendments that will facilitate the ability of funds and other issuers to raise capital through private placements. On August 26, 2020, the SEC adopted amendments to expand the definition of "accredited investor" found in Rule 215 and Rule 501(a) of Regulation D under the Securities Act of 1933, as amended ("Securities Act") [1]. The amendments were passed by a 3-2 vote of the SEC's Commissioners. The Adopting Release is available here.

The amendments:

- expand and clarify existing categories of accredited investors;
- add new categories of individuals and entities that will qualify as accredited investors; and
- moderately expand the definition of "qualified institutional buyer" or "QIB" in Securities Act Rule 144A and the permitted scope of "testing the waters" pursuant to Securities Act Rule 163B.

The amendments will become effective 60 days after publication in the Federal Register.

The accredited investor definition is significant to the scope of permitted investors in private placements undertaken in reliance on Rules 506(b) and 506(c) under the Securities Act (which form part of the safe harbor from the registration requirements of Section 5 of the Securities Act pursuant to Regulation D), and it also impacts certain other exemptions from the registration and plays an important role in other federal and state securities law exemptions. Under existing rules, accredited investors, as well as QIBs, are able to participate in offerings made in reliance on these rules that are not generally available to the public, including offerings by hedge funds, private equity funds and venture capital funds. Certain registered investment companies, mostly closed-end funds, also conduct offerings in reliance on these rules. The amended accredited investor definition expands the pool of eligible investors for exempt offerings and, as noted in the Adopting Release, provides a foundation for the SEC's ongoing efforts to evaluate and consider changes to the exempt offering framework as it continues to assess means by which access to the private markets by "retail investors" could be expanded.

Amendments Applicable to Individuals as Accredited Investors

The SEC expanded the definition of accredited investor regarding individuals to include: (i) "knowledgeable employees" of a private fund and (ii) natural persons holding certain professional certifications and designations or other credentials.

Knowledgeable Employees

The amendments will enable "knowledgeable employees" of a private fund to qualify as accredited investors for investments in the fund. The new category of accredited investor will be the same in scope as the definition of "knowledgeable employee" in Rule 3c-5(a)(4) under the Investment Company Act of 1940, as amended ("Investment Company Act"). This includes "executive officers"[2], directors, trustees, general partners, and advisory board members, or persons serving in a similar capacity, of a private fund[3] or an affiliated person of the private fund that manages the private fund's investments ("Affiliated Management Person"), as well as employees of the private fund or an Affiliated Management Person (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, other private funds or investment companies the investment activities of which are managed by such Affiliated Management Person of such private fund, or similar functions or duties for a prior employer, for at least 12 months. The Adopting Release noted that whether any particular employee participates in the investment activities of a fund is a determination that must be made on a case-by-case basis, and a person is determined to be a knowledgeable employee at the time of his or her investment. Consistent with Rule 3c-5(a)(4), the scope of "knowledgeable employees" for purposes of determining accredited investor status will not include employees who simply obtain information regarding a fund but do not participate in the investment activities of the fund.

The SEC further noted that the amendments do not limit accredited investor status to only those knowledgeable employees making investments in the private fund of which they participate in the investment activities. As a result, knowledgeable employees of an adviser managing several private funds would be deemed to be knowledgeable employees for purposes of investing in all of the adviser's private funds, provided that the knowledgeable employees participated in the investment activities of at least one of the funds managed by the adviser for the required period.

The SEC also stated that it would be appropriate to attribute a knowledgeable employee's accredited investor status to his or her spouse with respect to joint investments made by the knowledgeable employee and his or her spouse in a private fund, but expressly declined to extend the relief further to encompass additional familial relationships, such as dependents. The SEC did not address whether the attribution would be extended to spousal equivalents. Accordingly, dependents of a knowledgeable employee who are not themselves accredited investors may not hold a joint interest in a Section 3(c)(1) or Section 3(c)(7) private fund with the knowledgeable employee.

Natural Persons Holding Certain Professional Certifications and Designations or Other Credentials

The SEC added a new category to the definition of accredited investor that permits natural persons to qualify as such based on certain professional certifications, designations or other credentials issued by an accredited educational institution, which the SEC may designate from time to time by order. In conjunction with the Adopting Release, the SEC designated by an accompanying Order holders in good standing of Series 7 ("General Securities Representative"), Series 65 ("Uniform Investment Adviser"), and Series 82 ("Private Securities Offerings Representative") licenses as qualifying natural persons. Because in general it should be easy to verify the status of individuals meeting the requirements of this new category of accredited investor, this change may make it easier for issuers to rely on Rule 506(c) of Regulation D, which requires issuers to take reasonable steps to verify that purchasers in an offering are accredited investors, but does not prohibit "general solicitation" like traditional private offerings made under Rule 506(b).

Notably, the amended definition gives the SEC significant flexibility to designate, by order, additional professional certifications or credentials that would qualify natural persons as accredited investors in the future without the time-consuming process of formal notice and public comment. In determining whether to designate a professional certification or designation or credential from an accredited educational institution, the SEC will consider, among others, the following attributes:

- whether 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;

- whether 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;
- whether a person 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
- whether an indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

The SEC also adopted a good-standing requirement, but will not require that the individual practice in the fields related to the certification, except to the extent that continued affiliation with a registered firm is required to maintain the certification, designation, or credential. For example, an individual's registration as a Series 7 general securities representative lapses two years after the date that his or her employment with a FINRA member terminates.[4] An individual who ceases to be employed by a FINRA member but whose registration remains current will continue to qualify as an accredited investor until such registration lapses.

Further, the successful completion of the Series 65 examination alone does not convey the right to transact business prior to being granted a license or registration by a state securities administrator. Thus, to qualify as an accredited investor, a licensed investment adviser representative must obtain, and maintain in good standing, the individual's state-granted license or registration, which may be applied for following successful completion of the Series 65 examination.

Amendments Applicable to Entities as Accredited Investors

The amendments add the following types of entities to the definition of accredited investor: (i) qualifying limited liability companies; (ii) entities owning investments totaling in excess of $5 million; (iii) SEC and state-registered investment advisers and SEC exempt reporting advisers; (iv) certain family offices and family clients; and (v) Rural Business Investment Companies.

Limited Liability Companies ("LLCs")

The SEC added to the definition of accredited investor in Rule 501(a)(3) LLCs that (i) have total assets in excess of $5 million and (ii) were not formed for the specific purpose of acquiring the securities being offered. This codifies a longstanding position of the staff of the SEC's Division of Corporation Finance that LLCs satisfying the other requirements of Rule 501(a)(3) are eligible to qualify as accredited investors, even though the prior version of the rule had not specifically included these types of entities.

Entities Owning Investments in Excess of $5 Million

The amendments add a new catch-all category to the accredited investor definition that includes any entity that (i) owns "investments," as that term is defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and (ii) is not formed for the specific purpose of acquiring the securities being offered. For a private fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, or a commodity pool, the definition of investments includes uncalled capital commitments. The SEC stated that the intent of this new category is to capture all entity types not already included in the definition of accredited investor as well as those entity types that may be created in the future, so long as those entities meet the specified thresholds. The SEC believed the term "entity" was sufficiently broad in this context to encompass Indian tribes and the divisions and instrumentalities thereof, federal, state, territorial, and local government bodies, certain government and sovereign wealth funds and entities organized under the laws of foreign countries.

SEC and State-Registered Investment Advisers and SEC Exempt Reporting Advisers

The amendments add to the definition of accredited investor (i) investment advisers registered with either the SEC or any state securities administrator and (ii) exempt reporting advisers relying on either the venture capital fund adviser exemption in Section 203(l) or the private fund adviser exemption in Section 203(m) of the Investment Advisers Act of 1940, as amended ("Advisers Act"). The Adopting Release did not address exempt reporting advisers which solely report to one or more state securities administrators, such as advisers to solely venture capital or other private funds with total regulatory assets under management of less than $25 million (such advisers generally being prohibited from registering with the SEC).

Certain Family Offices and Family Clients

The amendments add to the definition of accredited investor a "family office" as defined in Rule 202(a)(11)(G)-1(b) under the Advisers Act, provided that such family office: (i) has at least $5 million in assets under management; (ii) was not formed for the specific purpose of acquiring the securities offered; and (iii) has its prospective investment directed by a sophisticated[5] person.

The final amendments to the definition of accredited investor also include "family clients," as defined in Rule 202(a)(11)(G)-1(b) under the Advisers Act, of a family office that meets the requirements stated above, provided that the prospective investment is directed by such family office.

The family office rule under the Advisers Act deems a person who receives assets upon the death of a family member or a key employee of the family office (or other involuntary transfer from a family member or a key employee) (a "beneficiary") to be a family client for one year following the involuntary transfer. In the Adopting Release, the SEC explained that such a beneficiary also will qualify as a family client for purposes of the accredited investor definition for one year. Because a person's status as an accredited investor is relevant at the time of investment, a beneficiary would not be required to unwind any securities acquired through an involuntary transfer from a family member or key employee of a family office (or made during the one-year period that the beneficiary is treated as a family client), but the beneficiary would not be considered an accredited investor in connection with the purchase of additional securities, unless the beneficiary qualified as an accredited investor on another basis.

Rural Business Investment Companies

The amendments add rural business investment companies ("RBICs"), as defined in Section 384A of the Consolidated Farm and Rural Development Act, as amended, to the definition of an accredited investor. RBICs generally include certain companies that are approved by the U.S. Secretary of Agriculture and that have entered into a participation agreement with the Secretary.

Other Matters Addressed

Spousal Equivalents and Joint Investments with Spouses

The Adopting Release also allows natural persons to include joint income from a "spousal equivalent" when calculating joint annual income under Rule 501(a)(6), and to include assets of spousal equivalents when determining joint net worth under Rule 501(a)(5). The amendments define the term "spousal equivalent" as a cohabitant occupying a relationship generally equivalent to that of a spouse. Previously, calculating joint annual income under Rule 501(a)(6) and determining joint net worth under Rule 501(a)(5) was limited to spouses of a natural person.

The Adopting Release added a note to Rule 501 to clarify the calculation of "joint net worth" of a natural person for purposes of Rule 501(a)(5). The note makes clear that assets that are not held jointly with a person's spouse or spousal equivalent may be included in the calculation.

Look-Through Entities

Under Rule 501(a)(8), an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors. The Adopting Release noted that, in some instances, an equity owner of an entity is another entity, not a natural person. The amended note to Rule 501(a)(8) clarifies that it is permissible to look through various forms of equity ownership under Rule 501(a)(8) to natural persons in those cases where an equity owner of an entity is itself an entity, but that owner-entity does not qualify on its own merits as an accredited investor (*e.g.*, if the owner-entity is an LLC that does not meet the $5 million in assets test).

Amendments Not Adopted

While the adopted amendments generally expand the potential pool of entities and individuals qualifying as accredited investors, the SEC declined to adopt a number of amendments suggested either in the Proposing Release or by commenters.

- In a closely watched decision, the SEC declined to change the existing net worth[6] and annual income[7] thresholds applicable to individuals. The SEC nonetheless estimated that the number of U.S. households that qualify as accredited investors had grown from approximately 2% of the population of U.S. households in 1983 to 13% in 2019 as a result of inflation.
- The SEC declined to adopt geography-specific net worth and annual income financial thresholds.

- The SEC declined to permit an investor advised by a registered investment adviser or broker-dealer to be deemed to be an accredited investor.
- The SEC declined to permit individuals with experience investing in exempt offerings (*g.*, at least 10 private securities offerings) to qualify as accredited investors.
- The SEC declined to modify the definition of accredited investor to include "qualified purchasers" as defined in Section 2(a)(51)(A) of the Investment Company Act (although in many cases a "qualified purchaser" will also be an accredited investor).

QIB Definition and Permitted Scope of "Testing the Waters"

Rule 144A provides a nonexclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain restricted securities to QIBs. In order to avoid inconsistencies between the entity types that are eligible for accredited investor status and QIB status, the amendments expand the definition of QIB in Rule 144A to include LLCs and RBICs, if they meet the $100 million in securities owned and invested threshold in the definition. The amendments also modify Rule 163B to increase the scope of entities that can be contacted if the issuer wishes to "test the waters" prior to a registered offering. Finally, the amendments add to the list of QIBs any institutional investors included in the accredited investor definition that are not otherwise enumerated in the definition of "qualified institutional buyer," provided they satisfy the $100 million threshold. As a result of this new "catch all" category, Indian tribes and the divisions and instrumentalities thereof, federal, state, territorial, and local government bodies, certain government and sovereign wealth funds, entities organized under the laws of foreign countries and bank-maintained collective investment trusts may now qualify as QIBs.

Takeaways

As stated above, the amendments will become effective 60 days after publication in the Federal Register. Accordingly, funds and other issuers will need to consider conforming amendments to offering documents and subscription and transfer agreements to encompass the revised and broadened definition of an accredited investor. The SEC's Adopting Release did not invite early application of the new definition. We believe that offerings in progress should await the effectiveness of the new rules before relying upon them.

The new definitions will expand the types of entities and individuals eligible to participate in private fund raising and Rule 144A sales, and may increase the ability of funds and other issuers to rely on Rule 506(c) of Regulation D. Potential new categories of investors should also review the changes to determine whether they will be able to make the appropriate representations as to their accredited investor status.

The SEC will have the opportunity to consider the implementation of these amendments in connection with its quadrennial review of the accredited investor definition required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Specifically, Section 413(b)(2)(A) of the Dodd-Frank Act provides that the SEC must review the accredited investor definition with respect to natural persons not less frequently than once every four years, with the next review required to be conducted in or by 2023.

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[1] The SEC proposed these amendments in a Proposing Release dated December 18, 2019, to which the SEC received a significant number of substantive comments. After considering the comments received, the SEC adopted the amendments substantially as proposed but with certain modifications in response to commenters' feedback.

[2] Rule 3c-5(a)(3) provides that the term "executive officer" means "the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the [private fund] or for an Affiliated Management Person of the [private fund]."

[3] In the Adopting Release, the SEC declined to include individuals investing in privately offered pooled investment vehicles that rely on an exemption other than Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act (*e.g.*, Section 3(c)(5) or Rule 3a-7), as "knowledgeable employees."

[4] See FINRA Rule 1210.08.

[5] The term "sophisticated" means having such knowledge and experience in financial and business matters that a person is capable of evaluating the merits and risks of a prospective investment. *See* Rule 506(b)(2)(ii) under the Securities Act.

[6] Rule 501(a)(5), as amended, will provide that the definition of an accredited investor includes "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, exceeds $1,000,000" excluding the value of the investor's primary residence.

[7] Rule 501(a)(6), as amended, will provide that the definition of an accredited investor includes "[a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year."

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