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The “Accredited Investor” Definition: The SEC Appears Poised to Both Loosen and Tighten It

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The SEC staff has continued to update, refine, and supplement the staff’s longstanding Compliance and Disclosure Interpretations (CD&Is) at a rapid pace to reflect the SEC’s current priorities. Earlier this year, the SEC posted new Securities Act CDIs regarding “integration” issues generally in connection with exempt offerings under Regulation D (the full list is available here). Included within this update was further refinement of the SEC’s position on “accredited investor” status, which is primarily a threshold qualification to invest in private companies and funds. While the SEC clearly intends to respond to the growing pressure to expand private investment opportunities for retail investors, it also appears wary of the ability of some retail investors to fully understand and evaluate these types of investments. The agency’s apparent opposing inclinations have manifested in its communications about potential amendments to the definition of “accredited investor.”

New Securities Act Rule CD&I 148.01 appears designed to tighten the verification requirements for issuers to determine that investors qualify as “accredited investors”, as a practical matter. The CD&I addressed the SEC’s rule on when two exempt offerings may, or may not, be “integrated” and thereby potentially undermining the regulatory basis for one or both exemptions under the federal securities laws. The scenario addressed in new CD&I 148.01 involved an initial offering conducted pursuant to Rule 506(c) of Regulation D, which permits general solicitation, followed by an offering made pursuant to Rule 506(b) of Regulation D, which does not. The staff stated that the issuer can sell to accredited investors that participated in the first offering in the subsequent offering if it had established a “pre-existing relationship” with those investors. There is nothing particularly controversial about that interpretation.

However, the staff added additional language to the CD&I which appears to be “dicta” but adds additional color to the scope of what qualifies as a substantive pre-existing relationship. Quoting prior SEC guidance, the staff wrote:

Whether the issuer has established a substantive relationship depends on the facts and circumstances. The quality of the relationship between an issuer (or its agent) and a prospective investor is the most important factor in determining whether a “substantive” relationship exists. In establishing a substantive relationship with a prospective investor, the issuer (or a person acting on its behalf) must have sufficient information to evaluate and must, in fact, evaluate the investor’s sophistication, financial circumstances, and ability to understand the nature and risks of the securities to be offered. An issuer cannot establish such a relationship solely through the passage of a specific duration of time or a particular short form accreditation questionnaire.

The term “substantive pre-existing relationship” is a term of art, and the SEC has provided a significant amount of guidance in the past, although market practice in some circumstances has evolved, albeit marginally, beyond the literal scope of the guidance by applying the underlying logic and principles.

In the CD&I, the SEC staff quoted some of the prior SEC guidance on “substantive pre-existing relationships,” which guidance had been issued at the time of more “regulatory” Administrations. Of course, the quoted language stands as the current law, strictly speaking, and that is fair enough. But we think a reasonable reading in context is that the staff has no intention of liberalizing this aspect of “accredited investor,” and even perhaps in practice intends to hold fast to the literal scope of the guidance, creating clear red lines in identifying pre-existing relationships to support the verification of accredited investor status.

On the other hand the SEC has in various contexts signaled an intent to liberalize “accredited investor” in communicating its inclination to expand the scope of who may qualify and what burdens issuers have to establish their accredited investor status. For example, at a roundtable the SEC last week, the SEC expressly signaled an intention to expand the scope of investors who qualify as “accredited investors.” For a more in depth review of the SEC roundtable, please refer to our alert. Of course, the focus of discussion at the roundtable was on tying “accredited investor” status to a retail investor’s financial sophistication, based for example on educational or professional background, which goes to the heart of the purpose of the definition. The SEC may be looking for a win-win, expanding the scope of eligible retail investors, without “watering down” the definition to include unsophisticated retail investors or relieving issuers of the burden to verify the accredited status of investors.

We will continue to monitor developments on this subject, and are happy to discuss our thoughts with clients and other interested parties.

Related Professionals

- **Frank Zarb**
  Partner
- **Louis Rambo**
  Partner