



SEC Expands the Definition of Accredited Investor

By: Xiang "Cathy" Zhang & David M. Lay

09.21.2020

On August 26, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended (the "Securities Act"), to add additional categories of natural persons and entities to the "accredited investor" definition. The Final Rule can be found [here](#). The amendments will become effective 60 days after publication in the Federal Register. As of September 21, 2020, the amendments had not been published.

The proposed amendments are important but not game-changing. They show the efforts the SEC has made to modernize the definition of accredited investors. The amendments reflect the SEC's intention that the "sophistication" of certain investors may be measured through means other than their financial resources (e.g., specific industry knowledge).

"Accredited investors" are a central component of Regulation D, which provides safe harbors for certain offerings to be exempted from the registration requirements under the Securities Act. For instance, in an offering under Rule 506(b) of Regulation D, an issuer may sell securities to an unlimited number of accredited investors and up to 35 non-accredited investors.^[1] Issuers largely rely upon the Regulation D safe harbors in private securities offerings.

New Categories of Natural Person Accredited Investors and Other Modifications

Historically, the accredited investor categories for natural persons are limited to wealthy individuals (as measured by net worth or income^[2]) and certain insiders (directors, executive officers, or general partners of the issuer). The SEC's amendments add alternative indicators of financial sophistication in order to allow more individuals who have sufficient knowledge and expertise to participate in a private offering.

The amendments expand the categories of qualifying natural persons to include:

- natural persons holding in good standing one or more professional certifications or designations or

other credentials from an accredited educational institution that the SEC has designated as qualifying an individual for accredited investor status;^[3] and

- natural persons who are “knowledgeable employees,”^[4] as defined in Rule 3c? 5(a)(4) under the Investment Company Act of 1940, of the issuer of the securities being offered or sold where the issuer is a private fund (i.e., an entity that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for the exclusion provided by either Section 3(c)(1) or Section 3(c)(7) of such Act).

In addition to the new categories of accretor investors, the amendments also allow natural persons to include “spousal equivalents” when calculating joint net worth or joint income under Rule 501. As used in the amendments, “spousal equivalent” means a cohabitant occupying a relationship generally equivalent to that of a spouse.

Furthermore, a proposed note to Rule 501(a)(5) clarifies that the securities being purchased by an accredited investor relying on the joint net worth test of Rule 501(a)(5) need not be purchased jointly^[5]

Notably, the SEC declined to raise the net worth or income threshold for qualifying accredited investors, which threshold has been criticized by some as having been eroded by inflation. This is consistent with the SEC’s intention to keep the pool open for more investors.

New Categories of Entity Accredited Investors

The amendments expand the categories of entity accredited investors to include:

- SEC- and state-registered investment advisers and rural business investment companies in the list of entities specified in Rule 501(a)(1);
- limited liability companies, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;^[6]
- any entities, of a type not listed in Rule 501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), not formed for the specific purpose of acquiring the securities offered, owning investments in excess of \$5,000,000 (with “investments” having the meaning set forth in Rule 2a51-1(b) under the Investment Company Act of 1940 (17 CFR 270.2a51- 1(b));
- “family offices,” as defined in Rule 202(a)(11)(G)¹ under the Advisers Act: (i) with assets under management in excess of \$5,000,000, (ii) that are not formed for the specific purpose of acquiring the securities offered, and (iii) whose prospective investment is 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 risks of the prospective investment; and
- “family clients,” as defined in Rule 202(a)(11)(G)¹ under the Advisers Act, of a family office meeting the requirements in new Rule 501(a)(12).

By adding the third category of entities above, the SEC intends to include any entity meeting the investment threshold that is not currently included in the definition and to provide flexibility to cover new

entity types created in the future.

In addition, a proposed note to Rule 501(a)(8) clarifies that, in determining accredited investor status under Rule 501(a)(8),^[7] one may look through various forms of equity ownership to natural persons. Accordingly, where an equity owner of an entity is another entity, not a natural person, one may look at such entity's natural person equity owners. Namely, for the purpose of determining accredited investor status under Rule 501(a)(8), the SEC intends that it should not matter whether the ownership is direct or indirect.

[1] For detailed requirements, see Rule 506(b).

[2] Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1,000,000, or any 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 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.

[3] The SEC has designated the General Securities Representative license (Series 7), the Licensed Investment Adviser Representative (Series 65), and the Private Securities Offerings Representative license (Series 82) as the initial qualifying certifications, designations, or credentials. The SEC may designate additional certifications, designations, and other credentials from accredited educational institutions from time to time in future orders.

[4] Under Rule 3c-5(a)(4), a "knowledgeable employee" with respect to a private fund is defined as any natural person who is: (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity of the private fund or an affiliated management person (i.e., the fund's investment manager) of the private fund; or (ii) an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial, or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates 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 the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund or substantially similar functions or duties for or on behalf of another company for at least 12 months.

[5] Interestingly, such clarification was not also added to Rule 501(a)(6).

[6] This amendment merely codifies the SEC's existing position on limited liability companies.

[7] Under Rule 501(a)(8), an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors.

Related People

- David M. Lay ? 804.420.6519 ? dlay@williamsmullen.com
- Xiang "Cathy" Zhang ? 804.420.6378 ? xzhang@williamsmullen.com

Related Services

- Emerging Companies
- Securities & Corporate Governance
- Corporate
- Mergers & Acquisitions