SEC ADOPTS AMENDMENTS TO EXPAND DEFINITION OF ACCREDITED INVESTOR

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U.S. Corporate Alert

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INTRODUCTION

On 26 August 2020, the U.S. Securities and Exchange Commission (SEC) adopted amendments to Rule 501(a) of Regulation D promulgated under the Securities Act of 1933, as amended (Securities Act), which expand the definition of "accredited investor" (the "Final Rule").[1] The Final Rule permits a greater number of investors to participate in private offerings by, among other things, formally including knowledgeable employees as accredited investors, broadening the accredited investor definition with respect to certain entities, such as family offices and limited liability companies, and extending the definition of accredited investor to include certain licensed professionals.[2] Notably, the Final Rule does not raise the standards for individual income ($200,000 for an individual, $300,000 for a married couple) or net worth ($1,000,000), which were established in 1982 and which some have argued have been eroded by inflation.[3]

The Final Rule and related amendments "are the product of years of effort by the Commission and its staff to consider and analyze approaches to revising the accredited investor definition," said Chairman Jay Clayton. "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. I am also pleased that we have expanded and updated the list of entities, including tribal governments and other organizations, that may qualify to participate in certain private offerings."

This client alert focuses on the impact of the Final Rule on private company capital formation in the start-up and emerging growth ecosystem, including angel and venture capital investors that support it.

Prior to approving the Final Rule, the Commission published a release proposing the new rule (the "Proposing Release") in the Federal Register on 15 January 2020.[4] As summarized below, the Final Rule enacts the rule largely as it as it was proposed in the Proposing Release. The Final Rule will become effective sixty (60) days after being published in the Federal Register (which effective date is expected to be in early November 2020).

FINAL RULE

Background

In 1982, the SEC adopted a series of rules, collectively designated "Regulation D," which provide certain issuers with safe harbors from the registration and prospectus delivery requirements of the Securities Act. Rule 506 of Regulation D provides a non-exclusive safe harbor, whereby an issuer that meets the requirements of the rule is deemed to have made an offering exempt from registration under Section 4(a)(2) of the Securities Act.

Under Rule 506, an issuer generally may sell an unlimited amount of securities to (i) up to 35 non-accredited investors and (ii) an unlimited number of "accredited investors." A purchaser is an accredited investor if an issuer "reasonably believes" that, at the time of the sale, the purchaser meets one of eight specific categories set forth in Rule 501(a).[5]

The Final Rule builds upon (1) a December 2015 SEC staff report, which examined the history of the accredited investor definition and considered recommendations for amending that definition (2015 Report);[6] (2) a June 2019 SEC concept release, which solicited comments on ways to harmonize the exempt offering framework, including revisions to the accredited investor definition (Concept Release);[7] and (3) the Proposing Release, which solicited comments on the proposal that formed the basis for the Final Rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required the SEC to undertake a review of the accredited investor definition every four years. The existing income and net worth standards in the definition were set in 1982 and some have argued they have been eroded by inflation. For reference, had these thresholds been adjusted for inflation, the income threshold today would be in excess of $500,000 for individuals ($740,000 for a married couple) and the net worth threshold would be in excess of $2.5 million. Rather than increasing the financial thresholds, which the SEC recognized would significantly restrict the pool of capital available to private offerings without addressing investor protection issues in a meaningful way, the Final Rule includes new criteria that serve as additional proxies for meeting the underlying objectives identified by the U.S. Supreme Court in its 1953 Ralston-Purina decision for defining the class of investors that have sufficient financial sophistication, access to information or ability to withstand investment loss to justify an exemption from the protection of the Securities Act.

In the Final Release, the SEC acknowledged that unregistered offerings under Regulation D, particularly those under Rule 506(b), play a significant role in capital formation in the United States.[8] An unnecessarily narrow definition would limit investor access to investment opportunities where there may be adequate investor protection given other factors such as investor's financial sophistication or knowledge and experience in financial matters. The Final Rule is crafted in such a way that the SEC believes balances investor protection considerations while also enlarging the pool of capital available to private issuers and funds.

Individual accredited investors

The Final Rule adds new categories to the definition of accredited investor that permit individuals to qualify as accredited investors based on certain professional certifications, designations or other credentials, or, with respect to investments in a private fund, based on the person's status as a "knowledgeable employee" of the fund.

Joint Net Worth and Spousal Equivalents Expanded

In addition, for purposes of the $1 million joint net worth requirement under Rule 501(a), the Final Rule adds a note that "joint net worth" represents the aggregate net worth of the investor and his or her "spousal equivalent," which encompasses any cohabitants occupying a relationship generally equivalent to that of a spouse. It also provides that an investor relying on the Rule 501(a) joint net worth test does not need to purchase the security jointly.

Net Worth and Income Thresholds Unchanged

Previously, the Concept Release requested comment on whether the SEC should revise the current individual income ($200,000) and net worth ($1,000,000) thresholds. In the Proposing Release, the SEC further considered

these thresholds, noting that the figures have not been adjusted since 1982. The SEC solicited comment on whether it should make a one-time increase to the income thresholds, or whether the final rule should reflect a figure that is indexed to inflation on a going-forward basis. In the Final Rule, the SEC concluded that no modifications to the thresholds are necessary at this time.

Certain Licensed Investment Professionals Automatically Qualify

The Final Rule allows an individual with certain investment-related professional certifications, designations or other credentials designated by SEC order (collectively, "credentials") to qualify as an accredited investor. In a separate order, the SEC designated individuals who possess the following professional certifications as qualified Accredited Investors:

- Licensed General Securities Representative (Series 7);
- Licensed Investment Adviser Representative (Series 65); and
- Licensed Private Securities Offerings Representative (Series 82).

The Final Rule also provides a non-exhaustive list of factors for the SEC to consider in issuing additional orders to include a designation, including whether (1) the credential arises out of examinations administered by a self-regulatory organization or educational institution: (2) such examinations are reasonably designed to demonstrate an individual's knowledge with respect to securities and investing: (3) the person with the credential can reasonably be expected to have sufficient knowledge to evaluate prospective investments; and (4) the credential is made publicly available. In addition, the individual is required to maintain such credentials in good standing, if applicable.

Knowledgeable Employees of Private Funds Deemed Accredited Investors

The Final Rule provides that "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act of 1940, as amended (the "1940 Act"),[9] of private funds are accredited investors. Rule 3c-5 already provided that securities owned by knowledgeable employees are excluded in determining whether the securities of a Section 3(c)(7) fund are owned exclusively by qualified purchasers. The Final Rule provides such employees also meet the accredited investor standard. Additionally, sponsors of Section 3(c)(1) funds are no longer required to count their otherwise non-accredited knowledgeable employee investors toward Rule 506(b)'s 35 non-accredited investor limit. A knowledgeable employee's accredited investor status extends to his or her spouse with respect to joint investments in relevant private funds.

Entities qualifying as accredited investors

Additional Qualifying Entities

The Final Rule expands the types of entities that qualify as accredited investors under Rule 501(a), adds a "catch-all" category for entities with $5 million in investments, clarifies the current ownership look-through provision and permits certain family offices to qualify, as described below.

Family Offices

The Final Rule designates "family offices" with at least $5 million in assets under management and their "family clients" (as each term is defined under Section 203 of the Investment Advisers Act of 1940, as amended (Advisers Act)) as accredited investors so long as the entity is not formed specifically for the purpose of acquiring

the offered securities and the 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.

Limited Liability Companies (LLCs)

Codifying the position of the SEC staff, LLCs have been added to the list of entities enumerated in Rule 501(a)(3), such that LLCs with total assets in excess of $5 million are considered accredited investors.

The SEC considered specifically including managers of qualified LLCs in 501(a)(4) as automatically qualified accredited investors but opted not to, following review of comments. The SEC believe that managers of qualified LLCs can still be accredited by virtue of their status as an "executive officer" under Rule 501(f).

All Entities with $5 Million in Investments

The Final Rule also creates a new "catch-all" category of accredited investors for entities with $5 million in investments that were not formed for the specific purpose of acquiring the offered securities.[10] This catch-all provision is intended to capture, among other types of entities, American Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country. The SEC explained that requiring $5 million in investments, rather than in total assets, was consistent with the majority of comments submitted in response to the Proposing Release and the Concept Release and "may better demonstrate that the investor has experience in investing."

Registered Investment Advisers

Under the Final Rule, investment advisers that are registered under the Advisers Act, or under state law (such registered investment advisers, "RIAs") are deemed accredited investors. The SEC, following requests for comments in the Proposing Release, also included exempt reporting advisers as qualified accredited investors.

Rural Business Investment Companies (RBICs)

RBICs are also included in the types of entities that are deemed accredited investors under Rule 501(a)(1). Similar to RIAs, the Final Rule does not impose a dollar thresholder and instead provides that an RBIC would qualify based solely upon its status as an RBIC.

Ownership Look-Through

Rule 501(a)(8) permits an entity to qualify as an accredited investor if all of the entity's equity owners are accredited investors. Given that an equity owner of an entity may also be an entity rather than a natural person, the Final Rule adds a note to Rule 501(a)(8) to clarify that an issuer may look through the various forms of equity ownership to the ultimate natural person owners in determining whether such owners are accredited investors.

CONCLUSIONS

The Final Rule and conforming amendments are consistent with a recent trend to expand investor participation in private offerings, and the Final Release notes that the Final Rule is part of a "broader effort to simplify, harmonize, and improve the exempt offering framework under the Securities Act to promote capital formation and expand investment opportunities while maintaining and enhancing appropriate investor protections. The Final Rule "provide[s] a foundation for [the SEC's] ongoing efforts to assess whether the exempt offering framework… is consistent, accessible and effective for both issuers and investors."

It is worth noting that the Final Rule does not alter the SEC's existing requirements for how issuers must determine whether investors satisfy the accredited investor criteria, which vary based on which category of Regulation D under which the issuer claims exemption. For example, offerings conducted under Rule 506(b), issuers may accept "self-certification" of accredited status from investors, while offerings under Rule 506(c), issuers must take reasonable steps to verify that each investor satisfies the accredited investor requirements.[11]

Many different constituencies in the investment community have a keen interest in the changes introduced by the Final Rule. The SEC acknowledged that the accredited investor definition is a central component of Regulation D and it was careful to note that taking too restrictive a position on eligibility could result in a significant constraint on the availability of funding. With the new criteria, the SEC effectively expands the pool of eligible investors for start-ups and collective investment vehicles, such as angel capital and venture capital funds, that support the emerging growth company ecosystem.

FOOTNOTES

[1] The final release (Final Release) is available here.

[2] The SEC also adopted certain conforming amendments to Rule 215, Rule 163B and Rule 144A under the Securities Act.

[3] For reference, had these thresholds been adjusted for inflation, the income threshold today would be in excess of $500,000 for individuals ($750,000 for a married couple) and the net worth threshold would be in excess of $2.5 million. In 2011, to conform the accredited investor definition to the requirements of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC amended the net worth test to exclude the value of an individual's primary residence when determining accredited investor status. The SEC specifically commented in the Final Release that the constraining effect adjusting the thresholds for inflation would have on the availability of capital outweighs any accompanying protection for investors, in the sense that the investor could more easily bear loss of investment.

[4] The Proposing Release is available here.

[5] Prior to adoption of the final rule, an individual was only an accredited investor if that individual: (1) had income in excess of $200,000 individually, or $300,000 with a spouse, in the two most recent years preceding the transaction and must have a reasonable expectation of maintaining that same income level in the current year; (2) had net worth in excess of $1 million, individually or with a spouse, without regard to the value of that individual's primary home; or (3) was a director, executive officer or general partner of the private fund or of a general partner of the private fund. Certain enumerated entities, as provided in Rule 501(a), with over $5 million in assets also qualify as accredited investors, while other entities, such as banks and registered investment companies, qualify without regard to the assets test. The Final Rule expands the list of entities which qualify.

[6] The 2015 Report is available here. In October 2014, the SEC also held a meeting of its Investor Advisory Committee to discuss recommendations from various subcommittees, including recommendations on new standards for the definition of "accredited investor" for natural persons. See K&L Gates' client alert: SEC Receives Recommendations on Changes to Accredited Investor Definition (10 October 2014), available here.

[7] The Concept Release is available here.

[8] The SEC noted that the estimated amount of capital raised under Rule 506 offerings in 2019 was $1.56 trillion compared to $1.2 trillion in registered offerings.

[9] Rule 3c-5(a)(4) under the 1940 Act defines a “knowledgeable employee” with respect to a private fund 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.

[10] The Final Rule incorporates the definition of “investments” from Rule 2a51-1(b) under the 1940 Act.

[11] For more information on the verification standards in Rule 506(c) offerings, see K&L Gates' client alert: Reasonable Steps to Verify (9 October 2013), available here.

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