

## SEC Revises Accredited Investor Standard

September 2, 2020

- Amendments to the "accredited investor" definition expand the categories of persons eligible to participate in private placements under Regulation D to include (i) individuals with certain professional licenses (Series 7, 65 and 82), (ii) any entity with more than \$5 million in investments, (iii) knowledgeable employees of a fund in which the employee is investing and (iv) family offices and their clients.
- The amendments also expand the types of entities eligible for Rule 144A offerings and make conforming changes to other rules.

On August 26, 2020, the U.S. Securities and Exchange Commission (SEC) adopted amendments<sup>1</sup> to Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), to expand the types of entities and the criteria for a person to be an "accredited investor" that is eligible to participate in private placements under Regulation D. Similarly, the SEC adopted amendments to expand the types of persons who could be "qualified institutional buyers" that are permitted to acquire securities under Rule 144A under the Securities Act. Finally, the SEC conformed other references in its rules, such as "testing the waters," the accredited investor definition in Regulation A and the requirements governing the categories of investors who must receive disclosure from broker-dealers under the "penny stock" rules.

### Amendments to the "Accredited Investor" Definition.

The accredited investor definition limits who can participate in private placements of securities and who can invest in private funds under U.S. securities laws.<sup>2</sup> The list of persons who qualify as "accredited investors" currently consists of a mix of regulated entities, individuals with a specified amount of assets or income and certain entities

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<sup>1</sup> The final rule release is available at <https://www.sec.gov/rules/final/2020/33-10824.pdf> and a press release summarizing the release is available at <https://www.sec.gov/news/press-release/2020-191>.

<sup>2</sup> Pursuant to Rule 506(b) of Regulation D, an issuer may offer and sell securities to investors acquiring for investment purposes without general solicitation so long as it has no more than 35 purchasers who are not accredited investors and the issuer provides specified information to non-accredited investors. Pursuant to Rule 506(c) of Regulation D, an issuer may offer and sell securities to investors acquiring for investment purposes with or without general solicitation so long as all purchasers are verified to be accredited investors. Issuers relying on the exclusions from the definition of "investment company" in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended, are prohibited from publicly offering securities and generally rely on Regulation D to offer their securities.

with specified levels of assets. The amendments to the accredited investor definition will permit each of the following additional persons to be an accredited investor:

- An individual that holds professional certification or designation or credentials in good standing from an accredited institution that the SEC has designated as sufficient to demonstrate his or her investment knowledge, which initially consists of Series 7, 65 or 82 exam,<sup>3</sup> but may be expanded in the future to encompass other exams or certifications as sufficient by order if the designations satisfy specified criteria.<sup>4</sup>
- Any entity not otherwise specified in the accredited investor definition and not formed for the specific purpose of acquiring the securities offered that owns more than \$5 million in "investments," as defined in Rule 2a51-1(b).<sup>5</sup>
- An individual who is a "knowledgeable employee," as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940, as amended, of the private fund issuer of the securities being offered or sold.<sup>6</sup>
- An investment adviser registered under the Investment Advisers Act of 1940, as amended (the "Advisers Act") or a person exempt from registration as a private fund adviser or a venture capital adviser.
- A "family office," as defined in Rule 202(a)(11)(G)-1 (the "Family Office Rule") under the Advisers Act not formed for the specific purpose of acquiring the securities offered with more than \$5 million in assets under management whose 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 investment.
- A "family client," as defined in the Family Office Rule, of a family office that satisfies the above requirements and whose investments are directed by that family office.

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<sup>3</sup> The SEC order naming those exams as meeting the attributes to qualify individuals as accredited investors is available at <https://www.sec.gov/rules/other/2020/33-10823.pdf>. The SEC focused on the fact that those licenses are publicly disclosed and could be verified. Therefore, it may be advisable for subscription documents to request disclosure of any licenses currently held (in case the SEC later expands the list of approved licenses), the licensing number (such as a Central Registration Depository number), whether such licenses are in good standing and either requesting a link to the public website that publicly discloses the status of the license or documenting the licenses through an independent search retained in the issuer's diligence file.

<sup>4</sup> In determining whether to designate a professional certification or designation or credential from an accredited educational institution for purposes of this new prong of the "accredited investor" definition, the SEC will consider, among others, the following factors: (i) the certification, designation or credential that 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; (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 either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

<sup>5</sup> Given the complexity of the definition of "investments," it may be advisable for subscription documents to include a schedule of the types of investments that are within the definition.

<sup>6</sup> Given the inherently fact-specific determination of whether someone is a "knowledgeable employee," the private fund's Chief Compliance Officer should verify that the potential investor satisfies the criteria of the rule and the no-action letters that provide further guidance, instead of accepting self-certification from the investor. The knowledgeable employee status would also apply to a spouse subscribing jointly with the knowledgeable employee.

- A Rural Business Investment Company.<sup>7</sup>

In addition, the SEC codified its previous guidance that a limited liability company (LLC) may be an accredited investor by adding it to the entities that are accredited due to having in excess of \$5 million in assets. Finally, the SEC expanded the term “spouse” used in the accredited individuals’ salary and net worth standard to include “spousal equivalents.”<sup>8</sup> A comparison of the current rule to the revised rule is available in [Appendix I](#) below.

## Conforming Changes to Other Rules

The SEC also amended other rules to conform to the amendments to the accredited investor definition described above. First, the SEC adopted an amendment to the definition of “accredited investor” in the SEC’s limited public offering rules, Regulation A, to incorporate the definition found in Regulation D into Regulation A instead of re-defining it in Regulation A. Second, the SEC amended the definition of “qualified institutional buyer” (QIB) in Rule 144A under the Securities Act<sup>9</sup> to include LLCs and any other institutional accredited investor of a type listed in Rule 501 of Regulation D as entities that may be QIBs due to owning at least \$100 million of securities. Third, the SEC expanded the types of institutional accredited investors that may receive “testing the waters” communications under Rule 163B under the Securities Act in connection with a potential public offering to include entities with more than \$5 million in investments and family offices, each as described above. Finally, the SEC expanded the carve outs for persons who are not required to receive “penny stock” disclosures to include entities with more than \$5 million in investments, family offices and family clients, each as described above.

## Conclusion

Clients will need to revise their subscription documents and accredited investor questionnaires for any new or continuing offerings in light of these amendments. How these amendments will need to be reflected will in part depend on whether the issuer is conducting an offering under Rule 506(b) under the Securities Act, which requires a reasonable belief that the potential investor is an accredited investor, or Rule 506(c) under the Securities Act, which requires verification of accredited status. Some of the new prongs of the accredited investor definition, such as possessing the requisite licenses or professional designation or being a “knowledgeable employee,” will likely require more than just completing a questionnaire. The amendments will become effective 60 days after publication in the Federal Register.

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<sup>7</sup> A “rural business investment company” is defined in Section 384A of the Consolidated Farm and Rural Development Act.

<sup>8</sup> “Spousal equivalent” is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.

<sup>9</sup> Rule 144A permits a person other than an issuer to sell securities that are not, at the time of issuance, listed on a national securities exchange (or convertible into such securities with less than 10% premium) at the time of issuance to QIBs so long as certain information is available and the purchaser is aware that it is acquiring the securities pursuant to that exemption.

## Appendix I

### Changes to Accredited Investor Definitions

- (a) Accredited investor. Accredited investor shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
- (1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any [investment adviser registered pursuant to section 203 of the Investment Advisers Act of 1940 or registered pursuant to the laws of a state; any investment adviser relying on the exemption from registering with the Commission under section 203\(l\) or \(m\) of the Investment Advisers Act of 1940; any](#) insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that ~~Act~~[act](#); any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; [any Rural Business Investment Company as defined in section 384A of the Consolidated Farm and Rural Development Act](#); any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;
  - (2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
  - (3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, ~~or~~ partnership, [or limited liability company](#), not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
  - (4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
  - (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, [or spousal equivalent](#)<sup>10</sup>, exceeds \$1,000,000-;

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<sup>10</sup> [The following definition of "spousal equivalent" was added in a new paragraph \(j\) to § 230.501: The term spousal equivalent shall mean a cohabitant occupying a relationship generally equivalent to that of a spouse.](#)

- (i) Except as provided in paragraph (a)(5)(ii) of this section, for purposes of calculating net worth under this paragraph (a)(5):
  - (A) The person's primary residence shall not be included as an asset;
  - (B) Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and
  - (C) Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability;
- (ii) Paragraph (a)(5)(i) of this section will not apply to any calculation of a person's net worth made in connection with a purchase of securities in accordance with a right to purchase such securities, provided that:
  - (A) Such right was held by the person on July 20, 2010;
  - (B) The person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and
  - (C) The person held securities of the same issuer, other than such right, on July 20, 2010.

Note 1 to paragraph (a)(5): For the purposes of calculating joint net worth in this paragraph (a)(5): joint net worth can be the aggregate net worth of the investor and spouse or spousal equivalent; assets need not be held jointly to be included in the calculation. Reliance on the joint net worth standard of this paragraph (a)(5) does not require that the securities be purchased jointly.

- (6) 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 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;
- (7) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); **and**
- (8) Any entity in which all of the equity owners are accredited investors.;

[Note 1 to paragraph \(a\)\(8\): It is permissible to look through various forms of equity ownership to natural persons in determining the accredited investor status of entities under this paragraph \(a\)\(8\). If those natural persons are themselves accredited investors, and if all other equity owners of the entity seeking accredited investor status are accredited investors, then this paragraph \(a\)\(8\) may be available.](#)

- (9) Any entity, of a type not listed in paragraphs (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;

Note 1 to paragraph (a)(9): For the purposes [sic] this paragraph (a)(9), “investments” is defined in rule 2a51-1(b) under the Investment Company Act of 1940 (17 CFR 270.2a51-1(b)).

- (10) Any natural person holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution that the Commission has designated as qualifying an individual for accredited investor status. In determining whether to designate a professional certification or designation or credential from an accredited educational institution for purposes of this paragraph (a)(10), the Commission will consider, among others, the following attributes:

- (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;
- (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 either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable;

Note 1 to paragraph (a)(10): The Commission will designate professional certifications or designations or credentials for purposes of this paragraph (a)(10), by order, after notice and an opportunity for public comment. The professional certifications or designations or credentials currently recognized by the Commission as satisfying the above criteria will be posted on the Commission’s website.

- (11) Any natural person who is a “knowledgeable employee,” as defined in rule 3c5(a)(4) under the Investment Company Act of 1940 (17 CFR 270.3c-5(a)(4)), of the issuer of the securities being offered or sold where the issuer would be an investment company, as defined in section 3 of such act, but for the exclusion provided by either section 3(c)(1) or section 3(c)(7) of such act;
- (12) Any “family office,” as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1):
- (i) With assets under management in excess of \$5,000,000,
  - (ii) That is 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

- (13) Any “family client,” as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1), of a family office meeting the requirements in paragraph (a)(12) of this section and whose prospective investment in the issuer is directed by such family office pursuant to paragraph (a)(12)(iii).

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