Securities Alert: SEC Expands Accredited Investor and Qualified Institutional Buyer Definitions

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After considering it for many years, on August 26, 2020, the Securities and Exchange Commission ("SEC") expanded the definition of "accredited investors" under Rule 501 ("Rule 501") promulgated pursuant to the Securities Act of 1933, as amended (the "Securities Act"). This expansion, the first change to the definition since 1989, will increase the pool of potential investors for both traditional issuers and funds. In addition, the SEC made certain corresponding changes to the definition of Qualified Institutional Buyer under Rule 144A promulgated pursuant to the Securities Act. Although the amendments do not adjust individual net worth or income thresholds, the new rule provides welcome additions and clarifications. The final rule is available here. The amendments will be effective on December 8, 2020.

Additional Accredited Investor Classifications

The amendments add several new categories of accredited investors to the definition:

License Holders. Individuals who are holders in good standing of one or more of the following licenses: Licensed General Securities Representative (Series 7), Licensed Investment Adviser Representative (Series 65) and Licensed Private Securities Offerings Representative (Series 82) will qualify as accredited investors, as the SEC believes such licenses provide a reliable indication that the holder of the license has a sufficient level of financial sophistication to invest in opportunities without the protection of a registration statement, irrespective of the individual's actual wealth. The SEC in the future may designate other qualifying professional certifications, designations and other credentials by an SEC order.

Regulated Investment Advisers. Registered investment advisers (both SEC- and state-registered investment advisers) and exempt reporting advisers (as defined under Section 203(l) or 203(m) of the Investment Advisers Act of 1940, as amended), will be considered accredited investors because they have the requisite financial sophistication to analyze investments.

Rural Business Investment Companies. Rural business investment companies ("RBIC") as defined under Section 384A of the Consolidated Farm and Rural Development Act will now be considered accredited investors since they are similar to small business investment companies which are already considered to be accredited investors.

Limited Liability Companies with Total Assets in Excess of $5 Million. The SEC has codified its prior interpretation that limited liability companies are accredited investors if they have total assets in excess of $5 million and were not formed for the purpose of acquiring the securities being offered. As the current accredited investor definition dates from 1989 and limited liability companies were not as popular then, they were not included in the 1989 definition. After 1989, the SEC provided guidance that limited liability companies with total assets in excess of $5 million and that were not formed for the purpose of acquiring the securities being offered would also qualify as accredited investors, and the expanded definition now formalizes that prior interpretation. The SEC did not

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specifically add limited liability company managers to Rule 501(a)(4) as accredited investors because it believes that these managers are likely to perform policy making functions similar to those of an executive officer and therefore would already be considered accredited investors as "any other person who performs policy making functions for the issuer."

Any Entity Owning Investments in Excess of $5 Million. Any entity owning investments, as defined in Rule 2a51-1(b) under the Investment Company Act of 1940, as amended (the "Investment Company Act"), in excess of $5 million and that were not formed for the purpose of acquiring the securities being offered will be accredited investors. This is intended to capture all entities not otherwise covered by Rule 501(a), such as Indian tribes and governmental bodies and funds, including other types of entities that may be created in the future.

Family Offices and Family Clients. An accredited investor will now also include a "family office" (as defined in the "family office rule" under 17 CFR Section 275.202(a)(11)(G)-1) that has at least $5 million in assets under management, is not formed for the specific purpose of acquiring the securities offered and its 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. In addition, accredited investor will also include "family clients" (as defined in the family office rule) of a family office that is an accredited investor, whose prospective investment is directed by such family office. The SEC believes that family offices and their family clients that meet the criteria set forth above can sustain the risk of loss of investment.

Spousal Equivalents to Joint Income and Net Worth Tests. The income and net worth tests under Rule 501(a)(5)-(6) will permit the income or net worth of spousal equivalents to be included. A "spousal equivalent" is a cohabitant occupying a relationship generally equivalent to that of a spouse.

Knowledgeable Employees of Private Funds. Knowledgeable Employees (as defined in Rule 3c-5(a)(4) under the Investment Company Act) of private funds will qualify as accredited investors with regard to investments into the private funds for which they work as well as other private funds managed by their employer. The SEC believes that having Knowledgeable Employees be able to invest in these private funds may further align the interests of the investors and the Knowledgeable Employees. The accredited investor status of the Knowledgeable Employee also applies to the Knowledgeable Employee's spouse for purposes of joint investments in private funds. Private funds, which include hedge funds, venture capital funds and private equity funds, are defined as issuers that would be an investment company under the Investment Company Act except for the exclusion from the definition of investment company in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

New Notes Added to Rule 501(a). The SEC also is adding two notes to Rule 501(a) to reflect prior SEC staff interpretations. One is to clarify that the calculation of "joint net worth" under Rule 501(a)(5) can be the aggregate net worth of the investor and his or her spouse or spousal equivalent without the purchase of the securities having to be a joint purchase. The second is to clarify that in determining accredited investor status under Rule 501(a)(8), where the owner of an entity is another entity that does not qualify on its own merits as an accredited investor, the various forms of equity ownership can continue to be looked through until there is a natural person. If the natural person owners of an entity are accredited investors and any other equity owners of the entity are accredited investors, the entity is an accredited investor under Rule 501(a)(8).

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Amendment to Rule 215. Rule 215 promulgated pursuant to the Securities Act, which defines an accredited investor under Section 2(a)15 of the Securities Act for purposes of Section 4(a)(5) of the Securities Act, will now cross-reference to the Rule 501(a) accredited investor definition.

Expansion of Test-the-Waters Communications

Currently, in registered offerings, issuers may engage in test-the-waters communications with qualified institutional buyers ("QIBs") and institutional accredited investors to gauge interest in a contemplated offering. The SEC is expanding the list of institutional accredited investors to include the ones referenced above under "Any Entities Owning Investments in Excess of $5 Million" and "Family Offices and Family Clients."

Expansion of Exemptions from Penny Stock Disclosure Requirements

Presently, Rule 15g-1 promulgated under the Securities Exchange Act of 1934, as amended, exempts from the "penny stock" disclosure requirements transactions with institutional accredited investors. The SEC is expanding the exemption to also cover the accredited investors described above under "Any Entities Owning Investments in Excess of $5 Million" and "Family Offices and Family Clients."

Expansion of Qualified Institutional Buyer Definition

QIBs are specified institutions with at least $100 million in securities owned and invested. The SEC is expanding the list of specified institutions to include RBICs and limited liability companies if they meet the $100 million threshold. In addition, to provide flexibility, the SEC is including as a QIB all entities not already defined specifically as a QIB if they meet the $100 million threshold. Since QIBs are not subject to the same restriction as accredited investors regarding not being "formed for the specific purpose of acquiring the securities offered," the SEC is making it clear with a note to the QIB definition that QIBs are not subject to that restriction.

Practice Points

With these amendments to the accredited investor definition, issuers and private funds will be able to expand the number of potential private investors. Therefore, both issuers and private funds will need to update their subscription agreements once the rules become effective to reflect the increased categories of accredited investors. In addition, issuers will have a broader group of potential investors with which to test the waters. Finally, the QIB market will be have a greater number of potential purchasers. All of these amendments reflect the SEC's goal of expanding investment opportunities and promoting capital formation while maintaining appropriate investor protections.

For further information, please contact a member of the Haynes Boone Capital Markets and Securities practice group and see these additional resources:

- SEC Adopts New Round of Amendments to Simplify and Modernize Disclosure Requirements (September 14, 2020)
- SEC Adopts Rule Amendments for Proxy Advisory Firms (September 1, 2020)
- SEC Issues Additional Guidance on COVID-19 Disclosure Considerations (July 13, 2020)

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