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SEC Broadens the Definition of Accredited Investors, Expanding Access to Private Markets

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On August 26, 2020, the Securities Exchange Commission (SEC) announced that it had adopted amendments that modified the statutory definition of "accredited investor," which is a key element in determining investor eligibility and thus a critical gatekeeper in who may invest in the private markets and in privately held companies. The accredited investor definition is a central component in several federal and state securities laws as well as multiple registration exemptions, including Rules 506(b) and 506(c) of Regulation D.

The original definition prevented investors who do not meet specific income or net worth tests from investing, regardless of their financial sophistication. The SEC amendments expand this definition by looking more closely at investors' professional knowledge, experience and/or credentials in addition to income and net worth. The amendments also provide an "investments" test for institutions--allowing all entities that meet the test to qualify as accredited investors.

SEC Chairman Jay Clayton stated that "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" and that the amendments were the "product of years of effort by the Commission" to revise the definition in the hope of expanding investment opportunities while maintaining appropriate investor protections and promoting capital formation.

Commissioner Hester M. Peirce embraced the move and said that "the accredited investor concept assumes that individuals cannot be trusted to exercise proper due diligence…[barring] individuals from having the investment opportunity in the first place" and that "freedom and responsibility are inseparable…[so] a regulator that does not acknowledge an individual's ability to bear the consequences of her actions

does not respect her liberty interests." Commissioner Elad L. Roisman noted that this definition "has long been an insurmountable hurdle for most people" who wish to invest outside of public markets, and that this opportunity will no longer be limited to only "the wealthiest among us."

Commissioners Allison Herren Lee and Caroline Crenshow voted against adoption of the final rule, noting the failure to index the dollar amounts in the rule to inflation and raising concerns about the quality of disclosure in private offerings and the need to protect senior investors. In a dissent, they said that the Commission's policy choices "fail to ensure that the accredited investor definition functions effectively to protect vulnerable investors, fail to acknowledge and analyze existing data revealing the risks these choices pose for investors, particularly seniors, and fail, once again, to address the lack of data regarding private markets more broadly."

Specifics

The "accredited investor" definition is found in the Commission's rules and the definition of "qualified institutional buyer" in Rule 144A under the Securities Act of 1933. Specifically, the amendments revise Rule 501(a), Rule 215 (by cross-referencing to Rule 501(a)), and Rule 144A of the Securities Act. See our alert on the proposed amendments here.

Rule 501(a) amendments to the accredited investor definition:

- Add a category allowing natural persons to qualify as accredited investors based on certain professional certifications or other credentials issued by an accredited institution. For example, holders in good standing of the Series 7, Series 65, and Series 82 licenses now qualify as accredited investors
- Include natural persons who are "knowledgeable employees" of a private fund
- Allow limited liability companies with $5 million in assets to be accredited investors, and add SEC- and state-registered investment advisers, exempt reporting advisers, and rural business investment companies (RBICs) to the list of entities that may qualify
- Add a category for any entity that owns "investments" (defined in Investment Company Act Rule 2a51-1(b)) in excess of $5 million, and was not formed for the purpose of investing in the offered securities; including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries
- Add "family offices" with at least $5 million in assets under management and their "family clients," (defined under the Investment Advisers Act)
- Add "spousal equivalent," so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors

The amendments expand the definition of "qualified institutional buyer" in Rule 144A to include limited liability companies and Rural Business Investment Companies with $100 million in securities owned and invested. Also, any institutional investor not listed as a "qualified institutional buyer" that meets the accredited investor definition is added to the list, if it satisfies the $100 million threshold. See the Final Rule here. The final rule will become effective 60 days after its publication in the federal register.

Michael Best's Securities & Capital Markets team has experts who advise private companies on compliance with the SEC regulations. Michael Best's Venture Best® team advises private companies of various sizes through the fundraising process. Please do not hesitate to contact a member of the Securities & Capital Markets or Venture Best® team for additional information on this SEC change, and what it means for financing transactions.

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