

What the SEC's Amendments to the Definition of "Accredited Investor" Mean for You

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After years of consideration, much debate and, despite disagreement among the Commissioners, on August 26, 2020, the Securities and Exchange Commission ("SEC") adopted amendments to Rule 501(a) under the Securities Act of 1933 (the "Rule") expanding the definition of "accredited investor," thus opening the private capital markets to additional categories of investors. These definitions, with the exception of a modification to the net worth test in 2011, had remained substantially unchanged since they were first adopted in 1982.

Qualifying under the Rule is important because accredited investors may invest in unregistered offerings for investments in alternative, potentially high-reward (albeit potentially high-risk) start-up and early stage companies, hedge, private equity, venture capital funds and the like.

Historically, the SEC used wealth "as a proxy for financial sophistication." Therefore, an individual had to meet either a wealth or income test - meaning a net worth in excess of \$1 million (not taking into account the equity value of their personal residence) or an annual income in excess of \$200,000 or a joint annual income with one's spouse in excess of \$300,000 to qualify as an accredited investor.

The amendments modify and update those long-standing tests and will now allow individuals possessing a measure of sophistication based on their professional knowledge and expertise, or certifications to qualify. The amendments also expand the list of entities that qualify as accredited investors by allowing any entity that meets an investments test to qualify. The amendments will become effective 60 days after the SEC's rule release is published in the Federal Register.

The amendments to the accredited investor definition in the Rule do the following:

- Add a new category to the definition that permits natural persons to qualify

as accredited investors based on certain professional certifications or designations or other credentials issued by an accredited educational institution, which the SEC may designate from time to time. In conjunction with the establishment of this new category, the SEC has designated holders in good standing of Series 7 (licensed general securities representative), Series 65 (licensed investment adviser representative), or Series 82 (licensed private securities offerings representative) licenses as qualifying natural persons. The SEC now also has the flexibility to reevaluate or add certifications, designations, or other credentials in the future, and will consider proposals from members of the public when adding to the qualifying list.

- Include as accredited investors natural persons who are “knowledgeable employees” of a private fund, as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940.
- Clarify that limited liability companies with \$5 million in assets are accredited investors and add SEC-registered and state-registered investment advisers, exempt reporting advisers, and rural business investment companies to the list of entities that qualify, without any requirement for a minimum amount of total assets.
- Add to the list of qualifying entities a new category for any entity, including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries, that own “investments” as defined in Rule 2a51—1(b) under the Investment Company Act, and “family offices” and their “family clients” in excess of \$5 million which have not been formed for the specific purpose of investing in the securities offered.
- Update the Rule to add “spousal equivalent” to the definition, so that spousal equivalents may be treated as spouses to pool their finances for the purpose of qualifying as accredited investors. The amendments define Spousal equivalent as a cohabitant occupying a relationship generally equivalent to that of a spouse.
- Clarify that investments by those qualifying under the joint net worth standard need not be held in joint name.
- Clarify the eligibility rules for entities which, on their own merits, do not possess all of the characteristics necessary for qualification (e.g. less than \$5

million in investable assets) may nonetheless qualify if all of its beneficial owners are accredited investors, regardless of how many layers must be analyzed before reaching those natural persons who qualify.

The amendments also expand the definition of “qualified institutional buyer” under Rule 144A to include limited liability companies and rural business investment companies if they meet the \$100 million in non-affiliated securities owned and invested threshold in the definition. Eligible entities include, but are not limited to, registered investment companies and investment advisers, insurance companies, ERISA employee benefit plans, tax exempt charitable organizations and others. The amendments also add to the list any institutional investors included in the accredited investor definition that are not otherwise counted in the definition of “qualified institutional buyer” as long as they satisfy the \$100 million threshold.

In order to maintain a consistency between the rules, once enacted, the SEC intends to adopt conforming amendments to Rule 163B under the Securities Act and to Rule 15g-1 under the Exchange Act.

Despite numerous comment letters, notably absent among the proposed changes, and subject to a dissenting [Joint Statement by two Commissioners](#), were provisions that would index the previously mentioned dollar thresholds which have remained virtually unchanged for nearly four decades. Those Commissioners also expressed concern that the modified definitions do not address the underlying suitability of the now-available investments to the newly expanded investor pool, especially senior citizens, as these newly-qualified investors have little ability to truly understand the assumed risks. Time will tell whether further changes will be made.

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