SEC Expands Definition of “Accredited Investor”

On August 26, 2020, the Securities and Exchange Commission (the “SEC”) adopted amendments to the definition of “accredited investor” in Rule 501(a) of Regulation D under the Securities Act of 1933 (“Securities Act”), which expand the category of investors eligible to participate in private offerings under Regulation D. The amendments create new categories of accredited investors, including those that qualify irrespective of wealth, on the basis that they have the requisite ability to assess an investment opportunity, and codify certain staff interpretative positions. The amendments, which were initially proposed on December 18, 2019, were adopted substantially as proposed with a few modifications, which we discuss below. The final rule will become effective 60 days after publication in the Federal Register.

New Categories of Accredited Investors

The SEC expanded the categories of accredited investors for both natural persons and entities.

- **Professional Certifications, Designations, or Credentials.** Under a new category in the amended definition, natural persons will be able to qualify as accredited investors based on certain professional certifications, designations, or credentials from an accredited educational institution that the SEC designates as qualifying an individual for accredited investor status. Such designations will be issued by an SEC order and posted to the SEC website, as modified from time to time. In the final rule, consistent with commenters’ suggestions, the SEC clarified that it will provide notice and an opportunity for public comment prior to issuing any final order regarding future designations of qualifying credentials.

An initial set of designations were adopted in a separate order for the following certifications or designations administered by the Financial Industry Regulatory Authority, Inc. (“FINRA”): (1) the Licensed General Securities Representative (Series 7); (2) the Licensed Investment Adviser Representative (Series 65); and (3) the Licensed Private Securities Offerings Representative

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1. [Amending the “Accredited Investor” Definition](https://www.sec.gov/rules/interp/2020/33-10824.htm), Release Nos. 33-10824; 34-89669. (Aug. 26, 2020) (“Adopting Release”). The amendments build upon a June 2019 concept release issued by the SEC, a December 2015 staff report that examined the background and history of the accredited investor definition, amendments that the SEC proposed in 2007 but did not adopt, and comments received on the foregoing. The Adopting Release also amends the definition of “qualified institutional buyer” to expand the list of entities that are eligible to qualify as qualified institutional buyers.


(Series 82). Individuals holding such licenses in good standing qualify as accredited investors even if they do not meet the income or net worth standards in the accredited investor definition. In determining whether to qualify additional professional certifications, designations, or credentials under the new category, the SEC will consider (1) whether it requires an examination administered by a self-regulatory organization, industry body, or accredited educational institution, (2) whether the examination is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing, (3) whether 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 (4) whether the relevant self-regulatory organization or other industry body has made information publicly available to indicate that an individual holds the certification or designation (e.g., FINRA's BrokerCheck or the SEC’s Investment Adviser Public Disclosure database), or whether an individual's certification or designation is otherwise independently verifiable.

- **Knowledgeable Employees.** The amendments will allow individuals who are “knowledgeable employees,” as defined in Rule 3c-5 under the Investment Company Act of 1940 (the “Investment Company Act”), of an issuer to qualify as accredited investors of that issuer. These are the same individuals that qualify as knowledgeable employees for purposes of Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act.

- **Catch-All for Entities Owning More than $5 Million in Investments.** Under the final rule, “any” entity will be able to qualify as an accredited investor if it (1) owns more than $5 million in “investments,” as defined in Rule 2a51-1(b) under the Investment Company Act, and (2) was not formed for the specific purpose of acquiring the securities offered. This catch-all category is intended to capture all existing entity forms not included in the existing definition, such as Native American tribes and governmental bodies, as well as those entity types that may be created in the future.

- **Family Offices and Family Clients.** The final rule creates a new category of accredited investors for certain “family offices” and their “family clients,” each as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (“Advisers Act”). A family office will qualify as an accredited investor if (1) it has in excess of $5 million in assets under management, (2) it was not formed for the specific purpose of acquiring the securities offered, and (3) its prospective investment is directed by a person with such knowledge and experience in financial and business matters that the family office is capable of evaluating the merits and risks of the prospective investment. Family clients of a family office that meets these requirements will also qualify as accredited investors, provided that the family clients' investments are directed by such family office.

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4 Amended Rule 501(a)(11).
5 Amended Rule 501(a)(9).
6 The existing definition lists only the following types of entities: a corporation, Massachusetts or similar business trust, partnership, or organization described in Section 501(c)(3) of the Internal Revenue Code.
7 Throughout the Adopting Release, the SEC refers to assets under management of at least $5 million. However, the text of the final rule states that the family office must have assets under management in excess of $5 million.
8 Amended Rule 501(a)(12).
9 Amended Rule 501(a)(13).
Particulars: Registered Investment Advisers, Exempt Reporting Advisers, and Rural Business Investment Companies. The amendments add SEC- and state-registered investment advisers, as well as investment advisers exempt from SEC registration under Section 203(m) or Section 203(l) of the Advisers Act, to the list of entities that qualify as accredited investors based on their status alone.¹⁰ The final rule also adds rural business investment companies to the list, allowing such companies to also qualify as accredited investors based on their status alone.¹¹

Clarifications and Codification of Staff Interpretative Positions

The final rules codify certain staff interpretative positions that relate to the accredited investor definition and address existing uncertainties.

- The amendments codify a longstanding staff position that limited liability companies are eligible to qualify as accredited investors if they satisfy the other requirements of Rule 501(a)(3).¹²
- The amendments add a note to Rule 501(a)(8) to make it permissible to look through various forms of equity ownership to natural persons when determining the accredited investor status of entities.¹³ This note is consistent with an existing staff interpretation which permits multiple look-throughs to qualify as an accredited investor.¹⁴
- The amendments allow individuals to include spousal equivalents when calculating joint income or determining joint net worth.¹⁵ “Spousal equivalent” is defined to mean any cohabitant occupying a relationship generally equivalent to that of a spouse.¹⁶
- The amendments add a note to Rule 501(a)(5) clarifying that the calculation of “joint net worth” for an individual may be the aggregate of their net worth with that of their spouse or spousal equivalent, and that the securities being purchased by an investor relying on the joint net worth test need not be purchased jointly.¹⁷ This note is consistent with an existing staff interpretation.¹⁸

Observations

As stated above, the amendments were adopted substantially as proposed, with a few modifications. We note below several observations.

- Financial Thresholds. The SEC sought comment in the Proposing Release as to whether the SEC should adjust for inflation the financial thresholds in the accredited investor definition. In the Adopting Release, the SEC declined to make any adjustments to the financial thresholds, citing considerations beyond the impact of inflation such as technological advances and changes in the availability of information. The SEC also stated that a significant reduction in the accredited

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¹⁰ Amended Rule 501(a)(1).
¹¹ Id.
¹² See Division of Corporation Finance interpretive letter to Wolf, Block, Schorr and Solis-Cohen (Dec. 11, 1996); Question 255.05 of Securities Act Rules Compliance and Disclosure Interpretations.
¹³ Amended Rule 501(a)(8).
¹⁴ See Question 255.06 of Securities Act Rules Compliance and Disclosure Interpretations.
¹⁵ Amended Rule 501(a)(5) and Amended Rule 501(a)(6).
¹⁶ Amended Rule 501(j).
¹⁷ Amended Rule 501(a)(5) and Amended Rule 501(a)(6).
¹⁸ See Question 255.11 of Securities Act Rules Compliance and Disclosure Interpretations.
investor pool resulting from an increase of the financial thresholds could have disruptive effects on the Regulation D market.

- **Verification of Accredited Investor Status Based on Professional Designations.** As described above, the amendments will permit natural persons to qualify as accredited investors based on certain professional certifications, designations, or credentials from an accredited educational institution. In the Adopting Release, the SEC states (as it did in the Proposing Release) that readily available information on whether an individual actively holds a particular certification or designation, such as information available on FINRA's BrokerCheck or the SEC's Investment Adviser Public Disclosure database, will be useful in verifying investors' accredited investor status under that prong of the definition for purposes of offerings conducted under Rule 506(c) of the Securities Act. After considering comments solicited in the Proposing Release, the SEC declined to include a requirement that natural persons qualifying under this prong of the accredited investor definition practice in the field related to the credentials, or have practiced for a minimum number of years. In doing so, the SEC cited concerns that such additional criteria would make it more difficult for investors to demonstrate, and issuers and market professionals to verify, accredited investor status, without providing significant additional protection for investors.

- **Exempt Reporting Advisers.** The proposed amendments did not include exempt reporting advisers in the definition of accredited investor. However, the SEC sought comment in the Proposing Release as to whether exempt reporting advisers should be included, and, as discussed above, exempt reporting advisers are included in the final rules. In adopting this modification to the proposed rules, the SEC stated that it believes that exempt reporting advisers, as advisers to private funds, have the requisite financial sophistication needed to conduct meaningful investment analysis, and that private funds themselves are institutional investors and all investors therein are presumed to be financially sophisticated.

- **Qualified Purchasers.** Although the SEC did not seek comment on this point, the Adopting Release notes that several commenters suggested modifying the definition of accredited investor to include “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act. The SEC declined to so modify the definition of accredited investor, stating that most qualified purchasers already meet the definition of accredited investor, but also that the accredited investor and qualified purchaser standards are distinct standards that serve a different regulatory purpose.

Finally, in anticipation of the effective date of the amendments, advisers to private funds and other pooled investment vehicles relying on Regulation D should update their subscription agreements to reflect the changes to the definition of accredited investor.
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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:
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