

CLIENT ALERT

# SEC Expands the Definitions of Accredited Investor and Qualified Institutional Buyer

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The Securities and Exchange Commission, by a 3-2 vote, recently adopted amendments expanding the categories of persons who qualify as an “accredited investor” under SEC rules for offerings exempt from registration under Regulation D and other purposes.<sup>1</sup> The SEC added several new categories of institutional and individual investors that have the knowledge and expertise to invest in our private capital markets without the need for the protections afforded by registration under the Securities Act of 1933. Certain conforming changes were also adopted, including to the definition of “qualified institutional buyer” in Rule 144A under the Securities Act. The amendments will be effective 60 days after publication in the Federal Register.

The amendments follow the SEC Concept Release issued in June 2019<sup>2</sup> that solicited public comment on possible ways to simplify, harmonize and improve the exempt offering framework under the Securities Act to promote capital formation and expand investment opportunities while maintaining appropriate investor protections, including potential changes to the definition of accredited investor. The SEC in December 2019 then proposed specific amendments to the definitions, that were adopted “substantially” as proposed, but with modifications in response to the extensive feedback received.<sup>3</sup> The

<sup>1</sup> See *Amending the “Accredited Investor” Definition*, Release No. 33-10824 (Aug. 26, 2020), available [here](#).

<sup>2</sup> See *Concept Release on Harmonization of Securities Offering Exemptions*, Release No. 33-10649 (June 18, 2019), available [here](#).

<sup>3</sup> See *Amending the “Accredited Investor” Definition*, Release No. 33-10734 (Dec. 18, 2019), available [here](#), and our related client memorandum, *SEC Proposes Expansion of Accredited Investor Definition* (Dec. 20, 2019), available [here](#).

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SEC characterizes the amendments as part of a “broader effort to simplify, harmonize, and improve the exempt offering framework under the Securities Act.”

### Background

Rule 506 of Regulation D promulgated under the Securities Act provides a safe harbor for issuers relying on the Section 4(a)(2) private placement exemption from the requirement to register a securities offering under the Securities Act. Subject to certain conditions, an issuer relying on the Rule’s safe harbor can offer and sell an unlimited dollar amount of securities to an unlimited number of accredited investors, without having to register the offering with the SEC. Rule 501(a) of the Securities Act defines an “accredited investor” as a person coming within any of the enumerated categories at the time of the sale of securities to that person. With respect to natural persons, the accredited investor qualifications previously depended exclusively on the person’s income and net worth (i.e., earnings of more than \$200,000 (\$300,000 with spouse) per year in each of the last two years or more than \$1 million in net worth, excluding the value of any primary residence) and, which have, with a notable exception,<sup>4</sup> remained largely unchanged for over 35 years. Rule 144A provides a non-exclusive safe harbor for unregistered sales of certain restricted securities to entities that qualify as qualified institutional buyers.

### Accredited Investor Changes

The SEC added the following categories of accredited investors to Rule 501(a) of Regulation D:

- **Individuals Satisfying Certain Professional Credentials**

The SEC added a new category to the definition that permits a natural person to qualify as an accredited investor based on the person holding a professional certification, designation or credential from an accredited educational institution, which the SEC has designated as qualifying an individual for accredited investor status by order. An individual who has passed the required examinations necessary for a Series 7, 65 or 82 license or registration, as applicable, and holds such license or registration in good standing, will now qualify as an accredited investor. For purposes of this category, issuers may fulfill their obligation to take reasonable steps to verify an investor’s accredited status by accessing FINRA’s BrokerCheck or the SEC’s Investment Adviser Public Disclosure database.

The SEC recognized that there may be additional professional certifications and designations that should similarly qualify an individual as an accredited investor. Following notice and an opportunity for public comment, the SEC expressly

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<sup>4</sup> In 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act amended the net worth category to exclude a person’s primary residence from the calculation and effective 2012 the SEC adopted provisions to deal with the treatment of debt secured by that residence. See our Client Memoranda, *Immediate Change in Accredited Investor Requirements in Dodd-Frank Act* (July 21, 2010), available [here](#), and *SEC Adopts Net Worth Standard For Accredited Investors Under Regulation D* (December 30, 2011), available [here](#).

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reserved the authority to designate by order other qualifying professional credentials in the future. An updated list of certifications and designations will be posted on the SEC's website. The amendment includes a nonexclusive list of attributes that the SEC will use to measure whether a professional credential may qualify a natural person for accredited investor status.

- **Knowledgeable Employees**

The amendments include as an accredited investor, with respect to investments in a private fund,<sup>5</sup> a natural person who is a "knowledgeable employee," as defined in Rule 3c-5(a)(4) under the Investment Company Act of 1940. A knowledgeable employee includes, among others, an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity of a private fund or private fund manager, as well as employees of a private fund who, in connection with their regular functions or duties, participate in the investment activities of a private fund or private fund manager, and have performed such functions and duties for at least 12 months. In keeping with the framework of the Investment Company Act, the SEC determined to attribute a knowledgeable employee's accredited investor status to his or her spouse or spousal equivalent with respect to joint investments in a private fund.<sup>6</sup>

- **Registered Investment Advisers, Exempt Reporting Advisers and Rural Business Investment Companies**

The SEC added as accredited investors both SEC and state-registered investment advisers, as well as exempt reporting advisers.<sup>7</sup> Although not included in its original proposal, the SEC determined that exempt reporting advisers possess the requisite financial sophistication to qualify as accredited investors. The SEC has also included Rural Business Investment Companies ("RBICs"), as defined in the Consolidated Farm and Rural Development Act, as accredited investors.

- **Limited Liability Companies**

The SEC codified a long-standing SEC staff position by specifically adding limited liability companies to the list of entities in Rule 501(a)(3) that qualify as accredited investors by having total assets in excess of \$5,000,000 and not being formed for the purpose of acquiring the securities being offered.

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<sup>5</sup> A private fund is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7) of that Act.

<sup>6</sup> For a more in depth discussion of "knowledgeable employees" under the Investment Company Act see our client memorandum, *SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds* (February 18, 2014), available [here](#).

<sup>7</sup> Exempt reporting advisers are investment advisers that qualify for an exemption from registration under Section 203(l) (an investment adviser serving as an adviser solely to one or more venture capital funds) or Section 203(m) (an investment adviser serving as an adviser solely to private funds and has assets under management in the United States of less than \$150 million) of the Investment Advisers Act of 1940.

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- **Entities Owning Investments Over \$5 Million**

The SEC also expanded the accredited investor definition to include any entity that owns “investments” in excess of \$5 million not formed for the specific purpose of acquiring the securities being offered. This new category uses the same definition of “investments” currently used to determine the qualified purchaser status of an investor pursuant to the Investment Company Act. The SEC explained that this new category is intended to serve as a broad “catch-all” category to include all entity types not already included within the definition, such as Indian tribes, governmental bodies and other entity types created in the future.

- **Family Offices and Family Clients**

The amendments include as accredited investors any “family office,” as such term is defined under the Investment Advisers Act of 1940,<sup>8</sup> (i) with assets under management in excess of \$5 million; (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 able to adequately evaluate the merits and risks of the prospective investment. Any “family client” (as defined under the Advisers Act) whose investment is directed by a family office satisfying the criteria described above will likewise qualify as an accredited investor, which allows a family client to “piggyback” on the sophistication of the family office for purposes of meeting the accredited investor requirement without having to itself meet the \$5 million threshold.

### Clarifying Notes

The SEC also clarified for purposes of the accredited investor definition that (i) “joint net worth” can be the aggregate net worth of the investor and spouse or spousal equivalent, regardless of whether the relevant investment is being purchased jointly; and (ii) an entity may qualify as an accredited investor under Rule 501(a)(8) if all the natural persons that directly or indirectly own such entity through various forms of equity ownership are themselves accredited investors. The term “spousal equivalent” has also been added to Rule 501 so that spousal equivalents may pool their finances for purposes of qualifying as accredited investors.

### No Adjustments to Financial Thresholds

The SEC had sought comment on other topics related to the accredited investor definition, such as adjusting financial thresholds of certain categories of accredited investor based on inflation. The SEC ultimately determined not to make any changes to the thresholds, stating that they are not persuaded that the investor protections provided by the thresholds have been meaningfully weakened over time as a result of inflation. The SEC also considered that a significant reduction

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<sup>8</sup> For a more in-depth discussion of family offices under the Advisers Act, see our client memorandum *SEC Adopts Rule Defining “Family Office” For Purposes of Exclusion from the Advisers Act* (June 29, 2011), available [here](#).

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in the accredited investor pool through an increase in the financial thresholds could have disruptive effects on the financial markets, but that it will continue to monitor the size of the accredited investor pool and the appropriateness of the financial thresholds.

### Qualified Institutional Buyer (“QIB”) Changes

Rule 144A provides a non-exclusive safe harbor for unregistered resales of certain restricted securities to QIBs. To ensure consistency with the types of entities that could qualify as an accredited investor under the amendments, the SEC adopted conforming changes to the definition of QIB in Rule 144A(a)(1) that add limited liability companies and RBICs to the types of entities that are eligible for QIB status if they meet the \$100 million threshold in Rule 144A in securities owned and invested. The amendments also add a “catch-all” category that permits institutional accredited investors under Rule 501(a), of an entity type not already included in the QIB definition, to qualify as QIBs where they satisfy the \$100 million threshold.

### Other Conforming Changes

1. Conforming changes were also adopted with respect to Rule 215 for purposes of the exemption under Section 4(a)(5) of the Securities Act, which generally exempts a securities offering to accredited investors if the offering amount does not exceed \$5 million. The definition of “accredited investor” in Rule 215 has historically been substantially consistent with, but not identical to, the definition in Regulation D. The SEC’s amendment now provides for Rule 215 to cross-reference the definition in Regulation D.
2. Rule 163B of the Securities Act, adopted in September 2019, permits issuers to use “test-the-waters” communications with qualified institutional buyers or institutional accredited investors in order to gauge their interest in an offering registered under the Securities Act. The SEC’s amendment to the accredited investor definition also adopts conforming changes for purposes of Rule 163B. Specifically, an accredited investor for purposes of Rule 163B will now also include: (a) the “catch-all” category of entities not formed for the specific purpose of acquiring the securities offered that own investments in excess of \$5 million; (b) any family office that qualifies as an accredited investor under Rule 501(a)(12); and (c) any family client that is an institution and qualifies as an accredited investor under Rule 501(a)(13).
3. Pursuant to Rule 15g-2 through Rule 15g-6 under the Securities Exchange Act of 1934, broker-dealers are obligated to disclose certain information to their clients before carrying out a trade in a “penny stock.” Rule 15g-1(b) provides an exemption from these disclosure requirements where the customer is an institutional accredited investor. The SEC amended Rule 15g-1(b) to include references to the same institutional accredited investors outlined in 2. above.

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### Practical Consequences

The amendments adopted by the SEC expand the universe of individuals and entities that are considered accredited investors, which the SEC expects will benefit issuers by potentially increasing the efficiency of the capital raising process in unregistered offerings, including the capital raising activities of advisers to private funds.<sup>9</sup> This benefit may be particularly significant with respect to individual investors, given the addition of several new categories not previously included within the definition, and the amendments open the door to future SEC orders to permit individuals that hold other professional certifications or credentials to become accredited investors. In light of these amendments, participants in the private offering markets, including securities issuers, broker-dealers, private funds and private fund managers, will need to update offering and subscription documents, as well as any applicable compliance policies and procedures that reference the accredited investor and QIB definitions.

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<sup>9</sup> Two Commissioners, Allison Herren Lee and Caroline Crenshaw, voted against the amendments, citing the failure to index for inflation going forward, failure to ensure that the accredited investor definition functions to effectively protect vulnerable investors, and a lack of data regarding private markets more broadly.

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