

SEC Promotes Capital Formation and Expands Investment Opportunities with Amendments to Accredited Investor Definition

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In an effort to provide companies with greater access to capital and to expand investment opportunities for certain investors, the U.S. Securities and Exchange Commission recently expanded the definition of an “accredited investor” in Rule 501(a) under the Securities Act of 1933. The amendments, which became effective in December 2020, add new categories of natural persons and entities to the accredited investor definition.

Whether investors are accredited or not matters primarily in private placements, because certain exemptions from the registration requirement of the Securities Act (or safe-harbors under those exemptions) require investors to be accredited.

For example, Rule 506(b) of Regulation D, which provides a safe-harbor under the private offering exemption in Section 4(a)(2) of the Securities Act, permits sales to up to 35 non-accredited investors and an unlimited number of accredited investors. However, if any investor is non-accredited, enhanced financial disclosures must be provided to all investors, which can be a reason to exclude non-accredited investors from Rule 506(b) offerings.

Alternatively, Section 4(a)(5) of the Securities Act provides an exemption for offerings up to \$5,000,000 made only to accredited investors. In addition, the securities laws of most states, including Illinois and Indiana, exempt from registration offerings made only to accredited investors.

Accredited-investor status can also matter for private resales of restricted securities, after they have been issued in an exempt offering. The “Section 4(a)(1-½)” exemption for private resales of restricted securities, although unenacted, is well-established, but its exact requirements are unclear. Section 4(a)(7) provides a safe-harbor with clear requirements for that exemption, including the requirement that each purchaser must be an accredited investor.

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Natural persons – i.e., individuals – are accredited investors if they qualify under the net worth test or the income test. The net worth test includes in the definition of accredited investor any natural person whose individual net worth, or joint net worth with that person’s spouse or spousal equivalent, exceeds \$1,000,000 (excluding the value of the person’s primary residence).

The income test for an individual to be an accredited investor requires individual income in excess of \$200,000, or joint income with that person’s spouse or spousal equivalent in excess of \$300,000, in each of the two most recent years and the reasonable expectation of reaching the same income level in the current year.

The new amendments to the definition of accredited investor do not change these monetary thresholds, which have remained the same for 38 years – with no adjustments for inflation, thereby increasing over time the pool of investors eligible to participate in private placements. However, the phrase “spousal equivalent” is newly added to the net worth and income tests. It is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.

The new amendments add a new category of natural persons who are accredited investors based on certain professional certifications, designations, or other credentials. The SEC is authorized to designate additional credentials from time to time by order, which it will post on its website. Currently, holders in good standing of Series 7, Series 65, and Series 82 licenses qualify as accredited investors.

“Knowledgeable employees” of “private funds” have also been added to the accredited investor definition. Knowledgeable employees include the executive officers, directors, trustees, general partners, advisory board members, or persons serving in similar capacities, of private funds or their affiliated management persons. They also include employees who, in connection with their regular duties or functions (other than clerical, secretarial, or administrative functions), participate in the investment activities of the private funds or their affiliated management persons.

Private funds – such as hedge funds, private equity funds, or similar funds – are issuers that would be investment companies (which invest in securities of other companies) *but for* the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Those sections exclude from the definition of “investment company” issuers with not more than 100 investors and issuers whose investors are all “qualified purchasers” such as individuals (together with spouses or spousal equivalents) with at least \$5,000,000 in investments, respectively, provided that the issuer is not making, or proposing to make, a public offering of its securities.

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Other new categories of accredited investor are types of entities, not natural persons. These include family offices, not formed for the purpose of acquiring the securities offered, with more than \$5,000,000 in assets under management, as well as the family clients of those family offices.

The expanded definition of accredited investor also includes any limited liability company or other entity, not formed for the purpose of acquiring the securities offered, with at least \$5,000,000 in investments. This is an extension of the previous definition of accredited investor's inclusion of corporations, partnerships, and trusts, not formed for the purpose of acquiring the securities offered, with at least \$5,000,000 in investments.

Other elements of the definition of accredited investor remain in effect, such as any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer. In addition, the definition of accredited investor still includes any entity whose equity owners are all accredited investors.

The SEC's amendments to the definition of accredited investor also do not alter the SEC staff's interpretation, which practitioners rely on, that a revocable trust is an accredited investor if all of grantors are themselves accredited investors, at least under the net worth test.

Finally, it is worth noting that the lead-in language to the definition of accredited investor continues to include not only natural persons or entities which come within the enumerated categories, but also those whom the issuer reasonably believes do so, at the time of the sale of securities to them.

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