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A Fireside Chat About Securities Regulation: Recent Updates on the Definition of Accredited Investor

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Howard: We last chatted about the efforts of the SEC to modify the rules on accredited investors in February and March, right before the pandemic lockdown [available here]. The SEC published the proposed rules on December 18, 2019 and then adopted final rules on August 25, 2020. On October 9, 2020, the final rules were published in the Federal Register, and they become effective 60 days thereafter, or on December 8, 2020.

As SEC Chairman Jay Clayton said in a statement released on August 26, 2020, "smaller and early stage businesses, [and] those in geographic areas with lower concentrations of accredited investors" otherwise lack access to "much needed seed and growth capital." Purportedly, this was even more so with respect to minority and women owned businesses (whether or not that concern might be better addressed through the banking sector was not considered.)

Commissioner Hester Peirce described the new rules as a "cautious expansion." Commissioner Peirce complained that the rule changes were too incremental, and that they unfairly infringe upon investors' rights to "sustain the risk of loss of investment or fend for themselves" by prohibiting them from investing in the private markets where, supposedly, there are far greater opportunities for growth than in the public markets.

Coming from the other side of the political divide, Commissioners Allison Lee and Caroline Crenshaw criticized the proposed rules as exposing investors to unjustifiable risk – including senior citizens. Their criticism hinges on the failure to raise the wealth and income thresholds. Commissioners Lee and Crenshaw also argued that private markets are far riskier than the other Commissioners admit.

Allan, is Commissioner Peirce correct? Are Commissioners Lee and Crenshaw right?

What do the final rules accomplish? What do they change? And what proposed changes did not make it into the final rules?

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Allan: What the final rules accomplish is to expand the categories of accredited investors to both new categories of natural persons and new categories of entities. While not as broad as some expected, they are a significant expansion from the manner in which the prior rules considered the issue of accreditation.

Howard: We talked previously about the focus that the prior rules placed on economic status as a proxy for investor sophistication. The prior rules established income and assets as the standard for determining whether or not an investor was sophisticated enough for presumably more complex and risky investments. As we've discussed, that framework came under criticism from, among others, Commissioner Peirce, for being unfair to those outside major metropolitan areas, who had lower income and asset levels. And as we discussed before, the mere fact that a dentist, for example, has a high net worth and income, doesn't mean she can analyze more esoteric investment opportunities. As a former SEC prosecutor, I prosecuted many cases where the victims were high income and high net worth individuals. Their business acumen in one field did not provide them with the necessary expertise to properly evaluate complex or risky investments. Clearly, the SEC agrees with me that income and wealth alone are not sufficient indicators of investor acumen. What have they done?

Allan: First, the SEC has expanded the definition of accredited investor to encompass certain career credentials that are a proxy for investor sophistication. The new rule, designated as Rule 501(a)(10), provides accredited investor status to "[a]ny natural person holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution that the Commission has designated as qualifying an individual for accredited investor status."

The SEC set up this general scaffolding with the idea that certain credentialing procedures might be a better guide to investor sophistication than wealth. Acceptable credentials will be designated and set out on the SEC website by SEC order based on various criteria further set out in the rule that will be adopted only on notice and an opportunity for public comment. Among those criteria is that it ensure that the holder of any such credential "has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment." Moreover, any evidence of qualification has to be verifiable, and any such certification must be "publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable."

For now, the credentials designated only include those holding certain securities licenses, namely, the Series 7 (General Securities Representative), 65 (Registered Investment Advisor representative) and Series 82 (Private Securities Offering representative).

The SEC considered, but rejected for now, all sorts of other credentials such as other securities licenses, and those licensed as attorneys, accountants, or MBAs. However, the SEC expressed an interest in potentially expanding the category of what other qualifications might suffice. The SEC says it wants to gain experience with this initial expansion, but left open the possibility it will order additional categories of natural persons to be included, and posited certain other examinations adequately measuring financial sophistication would be a possible expanded category.

Howard: Accreditation based on formal testing was not the only way in which the SEC expanded the definition of what qualifies as accreditation. They also added to the category of natural persons who qualify as accredited investors so called "knowledgeable employees" of certain investment funds. Previously, only a limited number of the employees of issuers were deemed accredited, including directors and executive officers (but only for offerings from that issuer). It seems like the SEC is now allowing an expanded class of employees of certain kinds of investment funds to be considered as qualified in connection with purchases of that investment fund's securities, depending on their status.

Allan, can you explain in greater detail the changes that the SEC made here?

Allan: The SEC has imported the definition of "knowledgeable employee" from Section 3(c)-5(a)(4) of the Investment Company Act, which uses that definition to omit counting such persons when determining whether a fund has more than 100 investors or any non-Qualified Purchasers, for purposes of applying the 3(c)(1) and 3(c)(7) exemptions from investment company registration requirements. As used in new Rule 501(a)(11), such a person shall be deemed an accredited investor but only in offerings for securities of the reference private fund.[1] The definition from the Investment Company Act includes any "Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Covered Company or an Affiliated Management Person of the Covered Company." It also includes employees who serve not solely in a clerical or administrative capacity, and who participate in the investment activities of such Covered Company.

The SEC analogizes the new definition to the current Rule 501(a)(4) definition for directors, executive officers or general partners of an issuer. Also, because these knowledgeable employees are now deemed accredited, they will not prevent a fund from qualifying under Rule 501(a)(8) when it has under $5 million in assets (this accredited investor definition applies to qualify an entity where all investors in that entity are accredited). The SEC believes that employees of managing entities of a fund will generally be accredited by virtue of their status as an "Affiliated Management Person". Furthermore, a knowledgeable employee's spouse can be attributed the status of knowledgeable employee when investments are held jointly.

Howard: The SEC also expanded the accreditation standard for certain entities as well. What are they?

Allan: The SEC has included several additional entities as automatically accredited. These include:

- **Registered Investment Advisors**. This would include both federal and state registered investment advisors. It also includes exempt reporting advisors.
- **Rural Business Investment Companies**. Similar to SBICs (Small Business Investment Company), they are defined under the Consolidated Farm and Rural Development Act as a company that has been approved by the Secretary of Agriculture and has entered into a participation agreement with the Secretary. These entities are exempt from Investment Advisor Act registration so that is the rationale of included them as accredited (since RIAs are now).
- **Limited Liability Companies** will now be accredited in the same manner as corporations, i.e., they are deemed accredited if they have over $5 million in assets and were not formed for the specific purpose of making the investment. This is less a change than a recognition of prior

practice, as the SEC had previously determined in no-action letters that LLCs should be treated as accredited if they meet the standard in the preceding sentence. However, even though it was suggested, the SEC did not explicitly include managers of an LLC in a new accredited investor category but stated they were already covered in Rule 501(a)(4) because of that section's reference to persons having duties similar to that of an executive officer.

- **Catch-all entities**. Entities not defined in existing entity categories (such as corporations or LLCs) now have a category that makes any such entity accredited if it has more than $5 million in investments and was not formed for the specific purpose of making the investment in the Regulation D Offering for which accredited status is claimed. This would include Indian Tribes, labor unions, government entities and funds, as well as certain entities organized under the law of a foreign jurisdiction (that does not have a corporate analogue since otherwise it would be permitted under Rule 501(a)(3)). "Investments" is defined in the same manner as for defining a qualified purchaser under the Investment Company Act, to include securities, real estate for investment purposes, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; as well as cash and cash equivalents. The idea behind using "investments" rather than assets is to imply a level of sophistication that owning, for example, a piece of land for non-investment purposes, may not imply.[2]

Howard: What about Family Offices? I understand that certain entities that don't have outside clients will now be considered accredited. Which, after all, makes some sense--why should entities that serve only a limited clientele be subject to a more restrictive standard that limits the investments they can make? What is included in this category?

Allan: The category of "Family Offices" and "Family Clients" sets out a classification that is an exemption from registration as an investment advisor. It generally refers to private funds that serve a single family, and make investments solely for the benefit of so-called family clients. To be accredited under new Rule 501(a)(12), a family office must have at least $ 5 million in assets under management.

The family clients that are accredited individually must have the investment directed by the family office to claim accredited status. "Family clients" generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities. Family clients already include the concept of spousal equivalents.[3] A spousal equivalent is defined as a cohabitant occupying a relationship generally equivalent to a spouse.

Howard: Notably, a few things were not included. Among them were various adjustments that Commissioner Peirce had been pushing. As we discussed last time, Commissioner Peirce believes that as income and asset levels are substantially higher in major metropolitan areas, it is unfair to rural areas to require the same income levels for accreditation. Thus, she had proposed that regional income and wealth disparities be taken into account. Note though, in one change under the new rules, spousal equivalents are now allowed to be counted for the existing income and net worth standards.

From the other side of the political spectrum, as noted in their comments, Commissioners Lee and Henshaw proposed that the failure to index the financial standards to inflation made them less

relevant over time. Among other things, they argued that as a significant amount of wealth was concentrated among senior citizens, the failure to index the financial standards exposed more senior citizens to potential wrongdoing, arguing that "unregistered offerings are consistently used in fraudulent schemes to target seniors. Thus, with today's amendments, we are putting some of the most vulnerable investors at risk."

Neither Lee nor Peirce got the changes they sought.

Howard: What else was not included?

Allan: Several other proposals failed to make it into the final rules. Among them, a category that would have permitted accreditation based on being advised by a registered investment advisor. Additionally, trusts cannot qualify generally based on accredited status of beneficiaries—this has not been changed. Except for certain grantor trusts, trusts would still need $5 million in assets, not been formed for specific purpose of investing in the securities at issue, and have their investments directed by a sophisticated person as defined in Regulation D.

A New Development

Allan: By the way Howard, the SEC made a major proposal on October 7th relating to permitting unregistered persons to act as "finders" for capital raising – a rather radical departure that we will need to elaborate on in our next chat.

Howard: As a former enforcement official, I found that proposal rather shocking, as it seems, at least at first blush, to reverse long-standing SEC views regarding finders. But let's save that for our next talk.

Endnotes

[1] The newly expanded definition for knowledgeable employee is as follows:

(11) Any natural person who is a "knowledgeable emp loyee," as defined in rule 3c-5(a)(4) under the Investment Company Act of 1940 (17 CFR 270.3c-5(a)(4)), of the issuer of the securities being offered or sold where the issuer would be an investment company, as defined in section 3 of such act, but for the exclusion provided by either section 3(c)(1) or section 3(c)(7) of such act.

[2] The new rule 501(a)(9) reads as follows: "Any entity, of a type not listed in paragraphs (a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), not formed for the specific purpose of acquiring the securities offered, owning investments in excess of 5,000,000." For the purposes this paragraph (a)(9), "investments" is defined in rule 2a51-1(b) under the Investment Company Act of 1940 (17 CFR 270.2a51-1(b)).

[3] The new rule is 501(a)(12) and 501(a)(13) and is as follows:

(12) Any "family office," as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1):(i) With assets under management in excess of $5,000,000, (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 capable of evaluating the merits and risks of the prospective investment;

(13) Any "family client," as defined in rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1)), of a family office meeting the requirements in paragraph (a)(12) of this section and whose prospective investment in the issuer is directed by such family office pursuant to paragraph (a)(12)(iii).

