

MEMO# 32133

January 8, 2020

SEC Issues Proposal to Update Accredited Investor and Qualified Institutional Buyer Definitions

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January 8, 2020 TO: ICI Members SUBJECTS: Closed-End Funds

Compliance

Distribution RE: SEC Issues Proposal to Update Accredited Investor and Qualified Institutional Buyer Definitions

The Securities and Exchange Commission recently issued a proposal to update the definitions of accredited investor and qualified institutional buyer (QIB) under the Securities Act.[\[1\]](#) The proposal would expand the pool of persons and entities that would meet both definitions. The Commission proposes to:

- Maintain the current income and net worth test thresholds for individuals to qualify as accredited investors, without adjustment for inflation;
- Allow individuals with credentials that demonstrate securities and investing expertise to be accredited investors, regardless of income or net worth;
- Add limited liability companies (LLCs), registered investment advisers, family offices, rural business investment companies (RBICs), and entities that own investments in excess of \$5 million to the list of entities that qualify as accredited investors; and
- Add LLCs, RBICs, and any institutional accredited investors that own \$100 million or more in securities to the list of entities that qualify as QIBs.

In addition, the Proposal requests comments on other possible ways to expand the definition of accredited investor.

Comments on the Proposal are due 60 days after Federal Register publication.

Proposed Changes to the Accredited Investor Definition for Individuals

Many investment opportunities in the exempt market, including access to some Regulation D Rule 506 offerings, are available only to investors who qualify as accredited investors.[\[2\]](#) Currently, the Securities Act permits only individuals who meet income or net worth tests to be accredited investors.[\[3\]](#) The Commission, however, has not updated the test thresholds for inflation in decades.[\[4\]](#)

The Proposal would maintain the current income and net worth tests. The Commission states that it does “not believe it necessary or appropriate to modify the definition’s financial thresholds [for inflation] at this time.”^[5] The Commission reasons that the thresholds still exceed average U.S. household income and net worth and expresses concern about the effect of an increase on investors in geographic areas with lower cost of living.

The Proposal instead would expand the pool of individuals eligible for accredited investor status based on knowledge and experience, regardless of income or net worth.^[6] Notably, the Commission proposes a list of criteria that it would consider in determining whether individuals with professional designations should qualify for accredited investor status.^[7] The criteria generally would require an individual to have a designation that demonstrates securities and investing knowledge and experience. The Commission expects that Series 7, 65, and 82 license holders would qualify for accredited investor status under these criteria, although it believes the criteria provide flexibility to include other designations in the future.^[8]

Further, the Commission proposes extending accredited investor eligibility to knowledgeable employees^[9] of private funds, regardless of the employees’ income or net worth. The Commission reasons that these employees, through their participation in the investment activities of private funds, are likely to be financially sophisticated. Further, allowing these employees to invest in the funds for which they work may help align employee interests with those of other fund investors.

Finally, the Proposal asks whether the Commission should expand the accredited investor definition to permit an individual advised by a registered financial professional, such as investment adviser or broker-dealer, to qualify as an accredited investor.^[10] Particularly, the Commission seeks feedback on whether this approach would provide sufficient investor protection.^[11]

Proposed Changes to the Accredited Investor Definition for Entities

Similar to its approach with individuals, the Proposal would expand the categories of entities that would be eligible as accredited investors. Specifically, the Proposal would add:

- Commission- and state-registered investment advisers;
- RBICs;^[12]
- LLCs that have assets in excess of \$5 million and were not formed for the purpose of acquiring the securities being offered; and
- Family offices^[13] with at least \$5 million in asset under management and their family clients, if the family office is directed by a person with knowledge and experience in financial and business matters and is not formed for the purpose of acquiring the securities being offered.

In addition, the Proposal would create a “catch-all” category for other types of entities that are not specifically listed in the accredited investor definition.^[14] To qualify as accredited investors, these entities would need to own investments in excess of \$5 million and not be formed for the specific purpose of acquiring the securities being offered. The Proposal applies an investments-owned^[15] rather than assets-owned requirement for this category because it believes investments-owned better demonstrates financial sophistication.

Proposed Changes to the QIB Definition

Rule 144A provides a non-exclusive safe harbor exemption from the Securities Act

registration requirements for the resale of restricted securities^[16] to QIBs. In creating a definition for QIBs, the Commission sought “to identify a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act’s registration provisions.”^[17] The current definition of QIB identifies categories of entities that are eligible to qualify. Each entity also must own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the QIB.^[18]

The Proposal would expand the categories of entities that are eligible for QIB status to be consistent with the Commission’s expansion of categories of entities eligible for accredited investor status. Any entity that meets the definition of accredited investor, even if not listed in Rule 144A, can qualify as a QIB once it satisfies the \$100 million securities-owned threshold. This expansion would include entities that would qualify as accredited investors through the proposed “catch-all” category.

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endnotes

^[1] See *Amending the “Accredited Investor” Definition*, Securities Act Release No. 10734 (Dec. 18, 2019) (the “Proposal” or “Release”), available at <https://www.sec.gov/rules/proposed/2019/33-10734.pdf>. The proposal builds on ideas discussed in a concept release that the Commission issued in June 2019. See *Concept Release on Harmonization of Securities Offering Exemptions*, Securities Act Release No. 10649 (June 18, 2019) (the “Concept Release”), available at <https://www.sec.gov/rules/concept/2019/33-10649.pdf>. See also the Institute’s comment letter in response to the Concept Release, available at <https://www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf>.

^[2] The Commission has previously stated the definition of accredited investor should identify “those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act registration process unnecessary.” See *Regulation D Revisions; Exemptions for Certain Employee Benefit Plans*, Securities Act Release No. 6683 (Jan. 16, 1987).

^[3] The current income and net worth tests for individuals are: having a net worth exceeding \$1 million (excluding the value of the individual’s primary residence), either alone or jointly with a spouse; or having an income exceeding \$200,000 in each of the two most recent years, or joint income with a spouse of \$300,000 in each of those years. See Securities Act Rule 501(a)(5)-(6). Individuals who are directors or officers of an issuer can also be accredited investors. Securities Act Rule 501(a)(4).

^[4] The current thresholds are substantially identical to those the Commission adopted in 1982. The Commission adopted an update in 2011, when it kept the net worth standard at \$1 million but, as required by Dodd-Frank, excluded the value of the investor’s primary residence when calculating net worth. See *Net Worth Standard for Accredited Investors*, Securities Act Release No. 9287 (Dec. 21, 2011), available at

<https://www.sec.gov/rules/final/2011/33-9287.pdf>.

[5] Proposal at 78. The Proposal notes that commenters to the Concept Release were mixed in response to whether to adjust the thresholds for inflation. Proposal 73-75.

[6] The Proposal also clarifies that individuals qualifying for accredited investor status based on joint net worth with a spouse need not purchase securities jointly with a spouse. Proposal at 46. Further, the Commission proposes that “spouse” for purposes of the rule should include “spousal equivalents.” Proposal at 65.

[7] The proposed criteria are: the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution; the examination or series of examinations is designed to reliably and validly demonstrate an individual’s comprehension and sophistication in the areas of securities and investing; 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 an indication that an individual holds the certification or designation is made publicly available by the relevant self-regulatory organization or other industry body. Proposal at 28.

[8] For example, the Proposal asks whether other types of designations, such as Certified Financial Analyst, or educational background or investment experience should qualify an individual as an accredited investor. The Commission notes that it would designate professional certifications or designations that meet the proposed criteria by means of a Commission order. It anticipates permitting public notice and an opportunity for comment before issuing such an order.

[9] Investment Company Act Rule 3c-5(a)(4) defines knowledgeable employees as (i) an executive officer, director, trustee, general partner, advisory board member, or persons services in a similar capacity, of the private fund or an affiliated management person (as defined in Rule 3c-5(a)(1)) of the private fund; and (ii) an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial, or administrative functions with regard to such company or its investments) who, in connection with his or her regular function or duties, participates in the investment activities of such private fund, or investment companies the investment activities of which are managed by such affiliated management person of the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

[10] Proposal at 83. The proposal notes that commenters to the Concept Release generally supported this idea, although others were opposed or expressed concern.

[11] The Proposal also asks whether individuals should be able to self-certify to accredited investor status. Proposal at 35-39.

[12] See Consolidated Farm and Rural Development Act Section 384A. RBICs are companies approved by the Secretary of Agriculture and that enter a participation agreement with the Secretary. RBICs are intended to promote economic development and the creation of job opportunities for individuals living in rural areas.

[13] Investment Advisers Act Rule 202(a)(11)(G)-1 defines family office as a “company (including its directors, partners, members, managers, trustees, and employees acting with the scope of their position or employment) that: (1) has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event; (2) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) does not hold itself out to the public as an investment adviser.”

[14] The Proposal gives examples of Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country. Proposal at 55.

[15] The definition of “investments” would be the same as that in Investment Company Act Rule 2a51-1(b).

[16] Restricted securities are generally securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. See Securities Act Rule 144(a)(3).

[17] See *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Securities Act Release No. 6806 (Oct. 25, 1988).

[18] Rule 144A(a). There are exceptions. A registered dealer can be a QIB if it owns and invests in the aggregate at least \$10 million in securities, or if it is acting in a riskless principal transaction on behalf of a QIB. Banks and other specified financial institutions are subject to an additional minimum audited net worth requirement of \$25 million.