

# SEC Updates Definition of “Accredited Investor”

## Corporate Alert

08.27.2020

### Related People:

Herbert P. Moore, Jr.

David J. Sorin

*The term “accredited investor,” as defined under Rule 501 of Regulation D of the Securities Act of 1933, as amended (the “Securities Act”), had not changed significantly since it was originally adopted in 1982. In June 2019, when the SEC asked for public comments on ways to “simplify, harmonize, and improve the exempt offering framework under the Securities Act,” McCarter, recognizing that the definition was impeding our clients’ ability to participate in private capital markets transactions, submitted a comment letter to the SEC calling for a change. Our letter was cited four times in the SEC’s December 2019 memo on the proposed new rules, and several of the concepts raised in our letter are reflected in the SEC’s August 2020 adopted amendments, an overview of which is below.*

The SEC has announced the adoption of several amendments to the definition of “accredited investor,” adding new categories of qualifying individuals and entities. These amendments are part of the SEC’s efforts to “simplify, harmonize, and improve” the rules governing the private offering of securities while maintaining investor protections.

As the valuations of many well-known private companies such as AirBnB, Stripe and Palantir have soared in recent years, and others such as Facebook, Zoom and DocuSign have gone on to have successful IPOs, there are many sophisticated investors who have not been able to participate in private capital markets because they did not qualify as accredited investors, defined for many years under the Securities Act generally as:

- Any individual whose net worth is over \$1 million;
- Any individual whose income in each of the two most recent years was over \$200,000 individually or \$300,000 with their spouse and who reasonably expects to reach the same level of income in the current year;
- Any entity in which all the individual owners are accredited investors; and
- Certain enumerated entities with assets in excess of \$5 million.

The implication of allowing only accredited investors to participate in private offerings of securities has been that only those who meet the qualifications have the financial sophistication necessary to evaluate a private investment opportunity and, perhaps more importantly, the ability to bear the risk of losing their investment.

To fully appreciate the impact this one term has had on a business’s ability to raise working capital or a venture fund’s ability to secure commitments from investors, it helps to step back and consider the broad framework of the U.S. securities laws governing private placements.

The Securities Act requires that all offerings and sales of securities must either be registered by the filing of a registration statement with the SEC that is then reviewed and declared effective by the SEC, or be exempt

from registration. Section 4(2) of the Securities Act offers the exemption from registration for “transactions by an issuer not involving any public offering,” *i.e.*, the “private placement” exemption.

By far, the most widely used exemption from registration by our company and fund clients is Rule 506(b) under Regulation D, which allows companies, venture funds and others to raise an unlimited amount of capital from an unlimited number of “accredited investors” through the offering and sale of securities, provided that (i) offers are made without general solicitation or advertising to market the securities, and (ii) sales are made only to accredited investors and to no more than 35 non-accredited investors.

Most companies, venture funds and others limit their offerings to only accredited investors because if non-accredited investors are participating, the disclosure obligations are significantly higher and more burdensome on the issuer. In fact, the SEC requires that issuers must give any non-accredited investors disclosure documents that contain the same type of information that goes into a registration statement, along with detailed financial statements.

There has been discussion in startup and venture capital ecosystems about updating the definition of accredited investor dating back to the dot-com boom, but the idea picked up steam during the consideration and passage of the Jumpstart Our Business Startups (JOBS) Act in 2012. In December 2015, the SEC issued a thorough [Report on the Review of the Definition of “Accredited Investor.”](#) After decades of considering comments and recommendations, the SEC amended the definition of accredited investor by adding:

- A new category to the definition that permits individuals to qualify as accredited investors based on certain professional certifications, designations or credentials issued by an accredited educational institution, which the SEC may designate from time to time. So far, the SEC has designated holders in good standing of the Series 7, Series 65 and Series 82 licenses as qualifying individuals;
- With respect to investments in a private fund, individuals who are “knowledgeable employees” of the fund;
- SEC- and state-registered investment advisers, and exempt reporting advisers (ERAs), and clarifying that limited liability companies (LLCs) with \$5 million in assets may be accredited investors;
- A new category for any entities, including Indian tribes, governmental bodies, funds and entities organized under the laws of foreign countries, that own investments, as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of \$5 million and that were not formed for the specific purpose of investing in the securities offered;
- Family offices with at least \$5 million in assets under management and their family clients, as each term is defined under the Investment Advisers Act; and
- The term “spousal equivalent” to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

These amendments were announced on August 26, 2020, and will take effect 60 days after publication in the Federal Register. We see them as positive updates to the accredited investor definition that will both expand investment opportunities for sophisticated individuals and open up new avenues for capital raising.