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Corporate, M&A, and Securities

SEPTEMBER 2, 2020 • NO. 6

Will Early Stage Businesses Have Better Access to Capital with the New "Accredited Investor" Definition?

On August 26, 2020, the Securities and Exchange Commission ("SEC") adopted new rules amending the definition of "accredited investor" in Regulation D under the Securities Act of 1933, which according to SEC Chairman Jay Clayton, "modernize and add much needed flexibility"[1] to that definition. The definition was expanded to add new categories of individuals and entities that the SEC believes have "sufficient knowledge and expertise to participate in investment opportunities" that are exempt from registration under the Securities Act. Amendments to the definition of "accredited investor" will become effective 60 days after publication in the Federal Register.

The definition of "accredited investor" is the cornerstone for determining who can participate in private placements of securities under Rule 506 of Regulation D—the most widely used exemption from the registration requirements of the Securities Act. The SEC estimated that of $2.7 trillion of new capital raised through exempt offerings in 2019, $1.56 trillion (or approximately 58 percent) was raised in Rule 506 offerings.

Prior to the adoption of the new rules, whether an individual qualified as an "accredited investor," was measured by looking at a person's income or net worth, either individual or joint with his or her spouse. These "wealth tests" were the sole determinant of whether an individual possessed adequate financial sophistication and ability to assess and bear risk of investments. Reliance on these "wealth tests" has not only prevented financially sophisticated investors who had neither the qualifying income nor net worth from participating in Rule 506 private placements, but it has also prevented "early stage businesses, those in geographic areas with lower concentrations of accredited investors, or founders without a wealthy friends-and-family network" from seeking "investments from otherwise financially sophisticated individuals to access much needed seed and growth capital."[2]

The amendments added a new category of "accredited investor" that allows individuals to qualify as accredited investors, irrespective of wealth, *based on holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution,* as designated by the SEC from time to time. In connection with the amendments, the SEC, by a separate order, determined that holders in good standing of the FINRA Series 7 (Licensed General Securities

1. SEC Chairman Jay Clayton, Statement on Modernization of the Accredited Investor Definition (Aug. 26, 2020).
2. See id.

Representative), Series 65 (Licensed Investment Adviser Representative), and Series 82 (Licensed Private Securities Offerings Representative) licenses will now qualify as accredited investors. The SEC may designate additional professional certifications or designations or credentials as qualifying for "accredited investor" definition by separate orders posted on the SEC's website.

The amendments also added a new category of *"knowledgeable employees"* of private funds[3] that are issuers of securities being offered in the private placement. Knowledgeable employees qualify as accredited investors because through "their knowledge…of the investment activities of the private fund, [they] are likely to be financially sophisticated and capable of fending for themselves in evaluating investments." The term "knowledgeable employee" is defined in the Investment Company Act of 1940 as (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person of such private fund (*i.e.,* an affiliated person that manages the investment activities of the private fund); or (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 functions or duties, participates in the investment activities of such private fund, other private funds, 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.

While retaining the existing income and net worth "accredited investor" tests, the new rules added the term "spousal equivalent" to the accredited investor definition, so that, like spouses, spousal equivalents could pool their finances for the purpose of qualifying as accredited investors. A "spousal equivalent" is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse. The new rules also clarified that for the purposes of the net worth test, assets of spouses or spousal equivalents need not be held jointly to be included in the calculation of the "joint net worth" and reliance on the joint net worth standard does not require that the securities offered in the private placement be purchased jointly.

In addition, the SEC expanded the list of entities that may qualify as accredited investors, by adding:

- SEC-and state-registered investment advisers and exempt reporting advisers under the Investment Advisers Act of 1940;
- Rural Business Investment Companies;
- any entity that is not already listed in the "accredited investor" definition (for example, Indian tribes, labor unions, government bodies and funds, and entities organized under the laws of a foreign country) that was not formed for the purpose of acquiring securities offered in the private placement and that owns "investments" (as such term is defined in the Investment Company Act of 1940) in excess of five million dollars;
- "family office" (as such term is defined in the Investment Advisers Act of 1940) that has assets under management in excess of five million dollars, that was not formed for the purpose of acquiring securities offered in the private placement and 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; and
- "family client" (as such term is defined in the Investment Advisers Act of 1940) of a family office qualifying as an accredited investor and whose prospective investment is directed by a person in the family office 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.

3. Private funds, such as hedge funds, venture capital funds, and private equity funds, are issuers that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for the exclusion from the definition of "investment company" in Section 3(c)(1) or Section 3(c)(7) of such act.

The SEC also codified a longstanding staff position that a limited liability company with assets in excess of five million dollars that was not formed for the purpose of acquiring securities offered in the private placement may be an accredited investor, in addition to corporations and partnerships already listed in the definition of the "accredited investor."

In addition, the SEC clarified that in the existing "accredited investor" category of any entity, in which all of the equity owners are accredited investors, it is permissible to look through various forms of equity ownership to natural persons in determining the accredited investor status of an entity.

While the SEC expanded and clarified the definition of "accredited investor," time will show whether these amendments will provide early stage businesses significantly broader access to seed and growth capital.

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