

Stradley Ronon Stevens & Young, LLP  
2005 Market Street  
Suite 2600  
Philadelphia, PA 19103-7018  
215.564.8000 Telephone  
215.564.8120 Facsimile  
www.stradley.com

With other offices in:  
Washington, D.C.  
New York  
New Jersey  
Illinois  
Delaware



www.meritas.org

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## SEC Proposes Expanded 'Accredited Investor' Definition

### Introduction

On December 18, 2019, a divided SEC proposed amendments (the Proposal) to the definition of “accredited investor” under Rule 501(a) of Regulation D<sup>1</sup> by modestly expanding the categories of individuals and institutions that would qualify as accredited investors and, therefore, have access to the private markets.<sup>2</sup> While such amendments, if adopted, would likely require most private fund managers to update their funds’ subscription agreements to reflect these new categories, the Proposal would be unlikely to expand significantly the pool of available investors for most private funds.<sup>3</sup> In his public statement<sup>4</sup> in connection with the Proposal, however, Chairman Jay Clayton framed the Proposal as “an important step . . . [with] more to come in this space in the coming months . . . .”<sup>5</sup> Further, echoing language from the SEC’s June 2019 Concept Release,<sup>6</sup> Chairman Clayton specifically referred to “examining whether appropriately structured funds can facilitate greater Main Street investor access to private investments . . . .”<sup>7</sup>

Below, please find a discussion of certain changes addressed in the Proposal that may be relevant to private fund managers.

### Natural Persons with Professional Certifications

In the Proposal, a majority of the SEC stated its belief that “relying solely upon financial thresholds may unduly restrict access to investment opportunities for individuals whose knowledge and experience render them capable of evaluating the merits and risks of a prospective investment . . . in a private offering, irrespective of their personal wealth.”<sup>8</sup> As such,

the proposed rule set forth in the Proposal (the Proposed Rule) would allow individuals with specified certifications, designations, or other credentials to qualify as accredited investors even if they do not meet the wealth or income tests currently in place. The SEC expects this category would initially include natural persons who hold either a Series 7 or Series 82 license or those who have taken and passed a Series 65 exam. Details, however, would be contained in a separate SEC order, which would provide the flexibility to add or delete particular qualifying certifications without additional rulemaking (i.e., without notice and comment or economic analysis).

### **Natural Persons Who Are Knowledgeable Employees of Private Funds**

In addition, the Proposed Rule would expand the definition of accredited investor to include “knowledgeable employees”<sup>9</sup> of private funds.<sup>10</sup> This amendment would provide that knowledgeable employees would be eligible to invest in their employers’ funds even if they do not otherwise qualify as accredited investors under the financial threshold tests.

### **Financial Thresholds Unchanged**

In addition to requests for comment on the various proposed amendments, the Proposal also requests comment on whether the financial thresholds within the definition should be adjusted. As drafted, the Proposed Rule would not modify the current levels of \$200,000, \$1 million, and \$5 million, which have been largely unchanged since 1982. Specifically, the Proposal requests comment on, among other things, whether indexing for inflation would be an appropriate benchmark. During the open meeting, Commissioner Allison H. Lee voiced her concern that, by not increasing the financial thresholds or adjusting them to reflect inflation, the Proposed Rule would “codify the toll that 37 years of inflation has already taken.”<sup>11</sup>

### **Clients of Registered Investment Advisers or Broker-Dealers as Accredited Investors**

Similarly, although not included in the Proposed Rule, the Proposal seeks comment on whether investors should be

considered accredited if they are advised by a registered investment adviser or broker-dealer but do not otherwise meet the financial thresholds. Commissioner Robert J. Jackson, Jr. voiced his concern that such an approach would have a detrimental effect on investors, pointing to evidence that “brokers who put investors in private securities are unusually likely to be the subject of both customer complaints related to sales practices and regulatory inquiries about misconduct.”<sup>12</sup> In response to Commissioner Jackson’s concern, Chairman Clayton noted that he views such an approach “with skepticism due to the lack of alignment of interests and sophistication.”<sup>13</sup>

### **Additional Proposed Changes**

The Proposed Rule also includes other additions and clarifications to Rule 501 as well as corresponding changes to other securities laws, certain of which are highlighted below:

- Rule 501(a)(1) would be expanded to include registered investment advisers as well as any Rural Business Investment Company.<sup>14</sup>
- Rule 501(a)(3) would be expanded to include limited liability companies, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5 million.
- Rule 501(a)(5) and (6) would be expanded to include “spousal equivalents”<sup>15</sup> under the net worth and income tests.<sup>16</sup>
- Rule 501(a)(9) would be added as a “catch-all” to include any entity, not formed for the specific purpose of acquiring the securities offered, that owns investments<sup>17</sup> in excess of \$5 million.
- Rule 501(a)(12) would be added to include any family office<sup>18</sup> that, among other requirements, has at least \$5 million in assets under management and whose prospective investment is directed by a person with certain financial sophistication.

Finally, in addition to the changes outlined above with respect to the definition of accredited investor for purposes of Regulation

**For more information, contact:**



**Sara P. Crovitz**  
202.507.6414  
scrovitz@stradley.com



**John P. Hamilton**  
212.404.0652  
john.hamilton@stradley.com



**J. Patrick Green**  
202.507.5151  
jgreen@stradley.com

D, the Proposed Rule would make corresponding changes to applicable definitions within Rules 215, 163B and 144A under the Securities Act as well as Rule 15g-1 of the Securities and Exchange Act of 1934, as amended.

## Conclusion

While the Proposed Rule would likely have a minimal impact on the fundraising audience available to most private fund managers, Chairman Clayton's remarks make clear that the SEC will continue to focus on greater access for retail investors to private markets, "particularly as a component of an investment portfolio that is analogous to the portfolio of a well-managed pension fund."<sup>19</sup> Further, the Chairman went on to highlight his belief that:

"it is important to focus on solutions that provide access to investment opportunities on substantially the same terms as those that would be available to institutional investors with protections — including alignment of interest between individuals and institutions, and transparency — that are akin to the protections in our public market. This alignment of interest is extremely important to me and I ask that commenters please recognize that I and many of my colleagues are skeptical of approaches that do not have either (1) demonstrated financial sophistication of the individual investor or (2) clear, ongoing alignment of interest with the sponsor."<sup>20</sup>

As such, if viewed in the broader context of the various topics explored in the Concept Release, which included, among other things registered feeder funds into private funds, modifications to the interval fund structure, and the ability to charge performance fees to registered funds, the Chairman's remarks and the Proposal itself imply there could, indeed, potentially be "more to come."

The comment period will close 60 days after the Proposal is published in the Federal Register.

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<sup>1</sup> Many private securities, including most private funds, are offered pursuant to an exemption from registration under Regulation D of the Securities Act of 1933, as amended (the Securities Act).

<sup>2</sup> See Amending the "Accredited Investor" Definition (<https://www.sec.gov/rules/proposed/2019/33-10734.pdf>), (proposed Dec. 18, 2019) (to be codified at 17 C.F.R. pts. 230, 240).

<sup>3</sup> For example, the Proposal would not change the definition of "qualified client" under Rule 205-3 of the Investment Advisers Act of 1940 (the Advisers Act), nor would it change the definition of "qualified purchaser" under Section 2(a)(51)(A) of the Investment Company Act of 1940 (the Investment Company Act).

<sup>4</sup> Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, "Modernizing the Accredited Investor Definition" (<https://www.sec.gov/news/public-statement/statement-clayton-2019-12-18>) (Dec. 18, 2019), (Clayton's Remarks).

<sup>5</sup> *Id.*

<sup>6</sup> Concept Release on Harmonization of Securities Offering Exemptions (<https://www.sec.gov/rules/concept/2019/33-10649.pdf>), 84 Fed. Reg. 30,460 (proposed June 18, 2019) (to be codified at 17 C.F.R. pts. 210, 227, 230, 239, 240, 249, 270, 274, 275).

<sup>7</sup> Clayton's Remarks, *supra* note 4.

<sup>8</sup> Proposal, *supra* note 2, at 27.

<sup>9</sup> Under the Proposal, "knowledgeable employee" would be defined as it is under Investment Company Act Rule 3c-5(a)(4).

<sup>10</sup> Funds excepted from the definition of investment company under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

<sup>11</sup> Allison H. Lee, Comm'r, U.S. Sec. & Exch. Comm'n, "Statement on the Proposed Expansion of the Accredited Investor Definition" (<https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor>) (Dec. 18, 2019) (noting that the failure to increase the thresholds to account for 37 years of inflation reflects a 550% increase in the number of qualifying households and that, if not adjusted in the future, in 30 years, 57.3% of U.S. households would qualify).

<sup>12</sup> Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Remarks During Open Meeting (Dec. 18, 2019), webcast available here ([https://www.sec.gov/video/webcast-archive-player.shtml?document\\_id=121819openmeeting](https://www.sec.gov/video/webcast-archive-player.shtml?document_id=121819openmeeting)) (2:05:05–2:05:10).

<sup>13</sup> Robert J. Jackson Jr., Comm'r, U.S. Sec. & Exch. Comm'n, "Statement on Reducing Investor Protections around Private Markets" (<https://www.sec.gov/news/public-statement/statement-jackson-2019-12-18-accredited-investor>) (Dec. 18, 2019).

<sup>14</sup> As defined pursuant to the Consolidated Farm and Rural Development Act.

<sup>15</sup> Defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse." Proposal, *supra* note 2, at 152.

<sup>16</sup> The staff also proposed adding a note to Rule 501(a)(5) to clarify that the calculation of "joint net worth" can be the aggregate net worth of an investor and his or her spouse or spousal equivalent and that the securities being purchased by an investor relying on the joint net worth test need not be purchased jointly.

<sup>17</sup> As defined in Investment Company Act Rule 2a51-1(b).

<sup>18</sup> As defined under Advisers Act Rule 202(a)(11)(G)-1. Note that Rule 501(a)(13) would also be added to include any "family client," as defined under the same Advisers Act rule. Proposal, *supra* note 2, at 152.

<sup>19</sup> Clayton's Remarks, *supra* note 4.

<sup>20</sup> *Id.*