SEC Proposes New Accredited Investor Definition

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On December 18, 2019, the SEC proposed an updated accredited investor definition. Accredited investors are eligible to participate in certain private and limited offerings, which are exempt from the registration requirements imposed by the Securities Act of 1933. According to the SEC, the new definition will increase access to investments.

Current definition of accredited investor

The current definition of an accredited investor includes:

- Any natural person whose individual or joint net worth with a spouse, at the time of purchase, exceeds $1 million; or
- Any natural person with an individual income in excess of $200,000 in each of the two most recent years or had joint income with that person's spouse that exceeded $300,000 in each of those two most recent years and has a reasonable expectation of reaching the same income level in the current year.

The current definition of accredited investor excludes the value of a natural person's primary residence from the $1 million net worth calculation.

Indebtedness, which is secured by an individual’s primary residence, is not treated as a liability unless the loan occurred during the sixty days prior to investing in the exempt offering and was not connected to the purchase of the primary residence. To avoid being treated as a liability, the loan must not exceed the estimated fair market value of the primary residence.

According to SEC chairman, Jay Clayton, “The current test for individual accredited investor status takes a binary approach to who does and does not qualify based only a person’s income or net worth.” In the SEC’s press release, Clayton expressed his opinion as follows:

> *Modernization of this approach is long overdue. The proposal would add additional means for individuals to qualify to participate in our private capital markets based on established, clear measures of financial sophistication. I also am pleased that the proposal specifically recognizes that certain organizations, such as tribal governments, should not be restricted from participating in our private capital markets.*

The proposed amendments would allow more investors to qualify as accredited investors if they possess the requisite professional knowledge, experience, or certifications, such as a Series 7, 65 or 82 license. Additionally, if the proposed amendments are adopted, a new eligible investor category of “knowledgeable employee” would be added for director, office and other executive positions of venture capital funds, hedge funds, and private equity funds.

The proposed amendments would also create a “catch-all” category for any entity owning in excess of $5 million in investments.

Specifically, the proposed amendments to the accredited investor definition would:

- Add limited liability companies that meet certain conditions, SEC and state-registered investment advisors and rural business investment companies (“RBICs”) to the current list of entities that may qualify as accredited investors;
- Add a new category for any entity, including Indian tribes, owning investments in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered;
- Add “family offices” holding at least $5 million in assets under management and their “family clients”; and
- Add the term “spousal equivalent” to the accredited investor definition to enable spousal equivalents to pool their finances in order to qualify as accredited investors.

It remains to be seen if all of these changes will be included in the final rule.

Qualified institutional buyer

The SEC also proposed modifications to the definition of qualified institutional buyer, which is found in Rule 144A under the Securities Act of 1933. The proposed amendments would add new categories of qualifying natural persons and entities and would expand the list of eligible entities covered by that definition.

The proposed amendments would include limited liability companies, as well as RBICs, if they meet the $100 million in securities owned and investment threshold. Furthermore, the proposed amendments would add a "catch-all" eligibility category for institutional investors of an entity type not already included in the definition if they meet the $100 million threshold.

Conclusion

While the proposed expanded definitions of accredited investor and qualified institutional buyer would allow more individuals and businesses to participate in private capital markets, investment advisors must still be cautious about the recommendations made, and ensure such recommendations are suitable and in the investor's best interest. Increased access to unregulated investments may not necessarily benefit certain investors. Although persons may fall within the definition of accredited investor, riskier investments may not be the right choice for their risk temperament, time horizon, and investment goals.

The SEC's press release and proposal can be found at https://www.sec.gov/news/press-release/2019-265.

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