WINSTON & STRAWN LLP

CLIENT ALERT

New SEC Rule Will Require Updates to Private Fund Documentation and Policies

SEPTEMBER 9, 2020

The new rule amends the definitions of accredited investor and qualified institutional buyer, in order to allow a broader range of persons and entities to participate in certain private placement investment opportunities

Introduction

On August 26, 2020, the Securities and Exchange Commission (SEC) adopted a final rule (the Final Rule) to amend the definitions of "accredited investor" and "qualified institutional buyer" (QIB) for purposes of the Securities Act of 1933, as amended (the Securities Act).[1] These definitions are widely used in documentation that managers send to investors in connection with private offerings of interests in funds, and are often included in policies and procedures required by the Investment Company Act of 1940, as amended (the Investment Company Act) and the Investment Advisers Act of 1940, as amended (the Advisers Act).

As explained in greater detail below, the Final Rule expands the definitions of accredited investor and QIB to include additional categories of eligibility. Because of the wide range of private offerings that must be restricted to accredited investors, the Final Rule will affect many, if not most, private fund managers, including managers of hedge funds, private equity funds, loan funds, venture funds, and real estate funds.

The Final Rule will likely require such managers to update their private placement memoranda, subscription documents, information brochures, and disclosure documents (among other forms of documentation) to account for the amendments to the definition of accredited investor. Additionally, the Final Rule will likely require updates to form representations or certifications related to the resale of securities in reliance on Rule 144A to account for the amendments to the definition of a QIB. Moreover, funds and investment advisers typically have policies and procedures related to compliance with the exemptions under the Securities Act for private offerings, which also may need to be updated to account for these definitional changes.

Separately, Rule 506(c) under the Securities Act requires issuers engaging in a general solicitation to take "reasonable steps" to verify that each investor is an accredited investor. Rule 506(c) further states that issuers will be deemed to meet this standard if, for investors claiming to be accredited based on factors other than income or wealth, the issuer obtains a written confirmation from certain persons (including a licensed attorney) that the

certifying person has taken reasonable steps to verify that the investor satisfies the relevant criteria.[2] Because the Final Rule expands the number of ways to qualify as an accredited investor outside of income or wealth (*e.g.*, by qualifying as a family office, family client or "spousal equivalent," among other things), the Final Rule may require a greater number of investors to obtain such a written confirmation.

The Final Rule will also allow funds and investment advisers to manage capital and take investments from a wider range of persons without forfeiting exemptions for private offerings from the otherwise-applicable disclosure requirements (*e.g.*, under Rule 506(b), offers and sales to non-accredited investors may only be made through disclosure documents that contain specific and detailed disclosures and financial information not otherwise found in a more traditional private placement memorandum). Additionally, because certain regulations by the Commodity Futures Trading Commission provide exemptions from the requirement to register as a commodity pool operator (CPO) to funds that limit their limited partners to accredited investors and satisfy certain other conditions,[3] the Final Rule may expand the scope of market participants that can invest in commodity pools without the operator needing to register as a CPO.

The Final Rule becomes effective 60 days after publication in the Federal Register (which has not occurred at the time of this publication). Therefore, generally speaking, offerings conducted after the effective date should reflect the amended definitions of accredited investor and (to the extent relevant) QIB. However, the amendments in the Final Rule only expand the definitions of accredited investor and QIB, rather than narrowing them. Therefore, an investor that qualifies under the old definitions will qualify under the new definitions.

The balance of this Client Alert will discuss the amendments to the accredited investor and QIB definitions that managers should consider incorporating in fund and adviser documentation going forward.

Accredited Investor Definition

The Final Rule includes a number of amendments and additions to the definition of an "accredited investor" in Rule 501(a) under the Securities Act, and replaces the similar (but not identical) definition of "accredited investor" in Rule 215 under the Securities Act with a cross-reference to Rule 501(a) (as amended by the Final Rule).

A. Natural Persons

- Credentialed Investors: One of the most notable aspects of the Final Rule is the shift in policy for individuals that qualify as accredited investors. Currently, the accredited investor definition primarily uses an individual's wealth as a proxy for financial sophistication. However, the amended definition will also allow individuals to qualify as accredited investors if they have "demonstrated the requisite ability to assess an investment opportunity."[4] This assessment will be primarily based on the possession of certain credentials, such as having passed certain financial market-oriented proficiency examinations (or by qualifying as a knowledgeable employee, as discussed below). The Final Rule therefore permits the SEC to designate certain professional certifications, designations, and other credentials as sufficient to convey accredited investor status on individuals holding those credentials. In conjunction with the adoption of the Final Rule, the SEC designated, by order, holders in good standing of the Series 7, Series 65, and Series 82 licenses as qualifying natural persons. The Final Rule notes that the SEC will provide notice and an opportunity for public comment before issuing any final order relating to future certifications and designations that may qualify as accredited investors. Additionally, the professional certifications, designations, and other credentials currently recognized by the SEC as qualifying as accredited investors will be posted on the SEC's website.
- Knowledgeable Employees of Private Funds: Under the Final Rule, "knowledgeable employees" (as defined in Rule 3c-5(a)(4) of the Investment Company Act) of 3(c)(1) and 3(c)(7) funds (*i.e.*, most private funds) and their affiliated management persons will qualify as accredited investors for purposes of offerings made by the fund. According to the SEC, these individuals are likely to be financially sophisticated and capable of evaluating investments based on their knowledge of and active participation in the investment activities of the private fund.[5] The Final Rule also clarifies that the SEC will attribute a knowledgeable employee's accredited investor status to his or her spouse

with respect to any joint investment made by any such knowledgeable employee and his or her spouse in a private fund.

- Spousal Equivalents: Previously, an individual could qualify as an accredited investor if the individual, together with his or her spouse, had a joint annual income over $300,000 or a joint net worth over $1 million. The Final Rule allows an individual to aggregate his or her income not only with his or her spouse, but also "spousal equivalents." Spousal equivalent is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse. The Final Rule also clarifies that an individual may rely on the joint net worth test even if the securities are not being purchased jointly with the individual's spouse or spousal equivalent.

B. Entities

- Registered Investment Advisers (RIAs) and Exempt Reporting Advisers (ERAs): The Final Rule includes within the definition of an accredited investor any investment advisers registered with the SEC or under the laws of the various states, and ERAs under section 203(l) or (m) of the Advisers Act.
- Rural Business Investment Companies (RBICs): RBICs are companies that are approved by the Secretary of Agriculture and that have entered into a participation agreement with the Secretary. They are similar to small business investment companies (SBICs) in that they are both intended to promote economic development and the creation of wealth and job opportunities in rural areas and among individuals living in such areas, and SBICs already qualify as accredited investors. The Final Rule therefore adds RBICs to the list of entities qualifying as accredited investors so that RBICs and SBICs are treated similarly.
- Limited Liability Companies (LLCs): Rule 501(a)(3) sets forth various types of entities that qualify as accredited investors if they have total assets in excess of $5 million, which did not previously include LLCs. SEC staff have long taken the position that LLCs can be accredited investors if they otherwise meet the conditions in Rule 501(a)(3), though, and the Final Rule explicitly incorporates this position into the text of the rule.
- Catch-All for Entities Meeting an Investments-Owned Test: The Final Rule adds a new provision that allows any type of entity not already included in Rule 501(a) to qualify as an accredited investor if it: (1) is not formed for the specific purpose of acquiring the securities offered, and (2) owns investments in excess of $5 million.[9] The SEC indicated that this new provision is intended to capture (among other entities) Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country.
- Family Offices: The Final Rule adds a new prong to the accredited investor definition for family offices (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act) that: (1) have more than $5 million in assets under management, (2) were not formed for the specific purpose of acquiring the securities offered, and (3) have a person directing the investment with such knowledge and experience in financial and business matters that the family office is capable of evaluating the merits and risks of the prospective investment.
- Family Clients: Under the Final Rule, family clients (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act) of family offices also will be accredited investors so long as the family office meets the definition of an accredited investor (as discussed above).
- Entities in Which All Equity Owners Are Accredited Investors: Under Rule 501(a)(8), an entity qualifies as an accredited investor if all the equity owners of that entity are accredited investors. However, in some instances, an equity owner of an entity is another entity. The Final Rule therefore amends Rule 501(a)(8) to clarify that, in determining accredited investor status under that rule, one may look through various forms of equity ownership to natural persons.

QIBS

Rule 144A under the Securities Act currently includes in the definition of a QIB (among other things) entities that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such person or entity. The Final Rule similarly expands this definition like the expansion of the accredited investor definition. Specifically, the Final Rule adds to the list of entities that qualify as QIBs: (1) RBICs and LLCs if they own and invest at least $100 million on a discretionary basis (to correspond to the amendments to Rules

501(a)(1) and 501(a)(3)), and (2) any institution not already enumerated in the QIB definition that is an accredited investor and meets the $100 million threshold. The Final Rule also states that an entity can qualify as a QIB if it was formed for the purpose of acquiring 144A securities.

No Adjustment for Inflation

One of the most controversial aspects of the Final Rule is what is *not* included. In proposing the amendments contained in the Final Rule, the SEC requested comment on whether the financial thresholds for accredited investors should be adjusted for inflation, since they have not been modified since 1982.[7] Given the amount of time that has passed since then, adjusting for inflation would result in the individual income threshold increasing from $200,000 to approximately $538,000 and the net worth threshold increasing from $1 million to approximately $2.7 million.[8]

The SEC decided against doing so, however, because such a significant increase would materially reduce the number of individuals that qualify as accredited investors. Additionally, the SEC stated that it does not believe the investor protections provided by the financial thresholds have been meaningfully weakened over time due to inflation. Commissioners Allison Herren Lee and Caroline Crenshaw disagreed, though, noting that there was widespread support for increasing the thresholds, and that lower thresholds could expose more investors, including seniors, to an increased risk of fraud (because, according to Commissioners Lee and Crenshaw, private markets are prone to fraud).[9] Commissioners Lee and Crenshaw therefore voted against the Final Rule, which was approved by a 3–2 vote.

The Final Rule is available here. We would be happy to assist you with assessing the impact of the Final Rule on your offering documents and other aspects of your business. If you have any questions about this client alert, please contact the authors or your Winston & Strawn relationship attorney.

[1] Amending the "Accredited Investor" Definition; Final Rule, Release Nos. 33-10824; 34-89669 (voting draft dated Aug. 26, 2020) (to be codified at 17 C.F.R. §§ 230.144A, 230.163B, 230.215, 230.501, 240.15g-1), *available here.*

[2] *See, e.g.*, 17 C.F.R. § 230.506(c)(2)(ii).

[3] *See*, *e.g.*, 17 C.F.R. § 4.13(a)(3).

[4] *See* Final Rule at 7.

[5] *See* Final Rule at 39.

[6] Note that Rule 501(a)(3) – *i.e.*, the prong of the "accredited investor" definition applicable to corporations, 501(c)(3) organizations, and now LLCs – requires such entities to have more than $5 million in total assets, but the new catch-all prong requires $5 million or more of investments. The catch-all prong is therefore a higher threshold than that set forth in Rule 501(a)(3).

[7] Under the current definition, individuals may qualify as accredited investors if (i) their net worth exceeds $1 million (excluding the value of the investor's primary residence), (ii) their income exceeds $200,000 in each of the two most recent years, or (iii) their joint income with a spouse exceeds $300,000 in each of those years and the individual has a reasonable expectation of reaching the same income level in the current year.

[8] *See* Final Rule at 144.

[9] *See* Allison Herren Lee and Caroline Crenshaw, *Joint Statement on the Failure to Modernize the Accredited Investor Definition* (Aug. 26, 2020), *available here.*

10 Min Read

Related Locations

Charlotte | Chicago | Dallas | Houston | Los Angeles | New York | San Francisco | Silicon Valley | Washington, DC

Related Topics

Corporate Finance | Securities and Exchange Commission (SEC) | Advisers Act

Related Capabilities

Transactions

Related Regions

North America

Related Professionals

Basil Godellas

Beth Kramer

Michael Wu

Cole Beaubouef

Jacqueline Hu

© 2024 Winston & Strawn LLP.