Hogan Lovells

Funds update

August 28, 2020

This is a commercial communication from Hogan Lovells. See note below.

SEC amends rules to expand definition of "accredited investor"

The U.S. Securities and Exchange Commission (SEC) adopted amendments on Wednesday, August 26 to several rules under the U.S. Securities Act of 1933 (Securities Act) to modernize, expand, and clarify the definition of "accredited investor" under Rule 501(a) and Rule 215 and the definition of "qualified institutional buyer" under Rule 144A.

The amendments, first proposed by the SEC in November 2019, are available in full here and become effective 60 days after publication in the Federal Register.

The amendments do not fundamentally alter the eligibility requirements for private equity investments. In the aggregate, however, they provide welcome clarity to several aspects of the definition. For private fund sponsors that raise capital in the United States, the proposed rules will incorporate certain qualified professionals as accredited investors, notwithstanding net worth or annual income if they hold certain industry designations or are "knowledgeable employees" under existing rules.

The "accredited investor" definition serves as a key threshold for individuals and entities to participate in private equity, venture capital, and other private capital investments without the disclosure burdens associated with offerings to a wider audience of less sophisticated investors. Private funds relying on Rule 506(b) for private placements under the Securities Act are limited to 35 non-accredited investors (subject to a higher standard of disclosure in many cases). Private funds relying on the more recent Rule 506(c), which allows for general solicitation, may not accept any investors other than accredited investors.[1]

The amendments would expand the "accredited investor" definition as follows:

- Individuals who have certain professional designations recognized by the SEC (and who are in good standing), initially FINRA Series 7, 65, or 82 licenses.[2] The adopting release makes clear that the SEC remains flexible and open to adding future clarifications or designations.
- Individuals who are "knowledgeable employees" will also qualify as accredited investors. The amendment relies on the definition of "knowledgeable employee" under Rule 3c-5 of the U.S. Investment Company Act of 1940 (Company Act). Knowledgeable employees have, since 1997, been excluded in determining whether a fund meets either the Section 3(c)(1) or Section 3(c)(7) exemptions from registration under the Company Act. Until these amendments, however, knowledgeable employees had no such corresponding exclusion under the Securities Act. The amendments, therefore, give regulatory certainty to employees who do not otherwise meet the "accredited investor," particularly in regards to the disclosure requirements of Regulation D.

1 Accredited investors traditionally have included the following categories, each as of the time of the sale of securities:

- individuals with a net worth (or joint net worth with a spouse) of US$1 million, excluding the value of a primary residence;
- individuals with an annual income of US$200,000 in each of the two most recent years (or a joint annual income of US$300,000), with the expectation of reaching the same income level in the current year;
- entities with total assets of at least US$5 million;
- state plans and certain employee benefit plans with total assets of at least US$5 million;
- entities in which all the equity holders are accredited investors or;
- certain enumerated entities, i.e. certain banks and savings and loan associations, registered broker-dealers, registered investment companies, and small business investment companies.

2 Because the initial universe of designated professional qualifications is limited to certain categories of FINRA licensees, this element of the relief may not initially provide significant practical benefit to private equity fund managers who are not affiliated with a FINRA member firm until the universe is expanded.

— It is important to note that Rule 3c-5(a)(4) does not include all fund sponsor employees as "knowledgeable employees," but only (i) executive officers, directors, trustees, general partners, advisory board members, or affiliated management persons, or (ii) persons serving in a similar capacity, or any employee who, in connection with his or her regular functions or duties, participates in the investment activities of the private fund for at least 12 months. The definition expressly excludes employees performing solely clerical, secretarial, or administrative functions, and may even exclude certain officers in some cases. The determination of which personnel of a particular fund sponsor meets the "knowledgeable employee" standard typically is a highly facts-and-circumstances intensive test that must be applied on a case-by-case basis. Nonetheless, as certain fund professionals will also hold the securities licenses described above, the qualification of those professionals as accredited investors also potentially provides more certainty in making determinations under Regulation D.

In addition to the foregoing rule changes of particular importance to private fund sponsors seeking to align professional employees' interests, the following additional rule changes were also made:

- "Spousal equivalents" (i.e. anyone in domestic partnerships, civil unions, and the like) will be treated as spouses for purposes of the definition.
- A new note to Rule 501(a)(5) clarifies that the calculation of joint net worth of an investor and his/her spouse (or, as newly defined, his/her spousal equivalent) may be the aggregate net worth of the two spouses (or spousal equivalents). Furthermore, the securities being purchased by an investor relying on the joint net worth test need not be purchased jointly.
- Certain additional types of entities now also qualify as accredited investors: (i) state and federally registered investment advisers (including, specifically, exempt reporting advisers), (ii) rural business investment companies (RBICs), and (iii) certain "family offices" and "family clients" as defined under the U.S. Investment Advisers Act of 1940.
- The amendments also formally add limited liability companies (LLCs) to the list of entities that will qualify as accredited investors so long as each such LLC has over US$5 million in assets, codifying a long-standing SEC staff position. Furthermore, the amendments create a new catch-all entity category: "any entity owning investments in excess of US$5 million that is not formed for the specific purpose of acquiring the securities being offered." This is intended to include in the definition certain state and local government entities and Indian tribes as accredited investors and also to capture new forms or types of entities that may be created in the future. Note that "investments" in this new catch-all category is defined by reference to the definition of "investments" in Rule 2a51-1(b) under the Company Act.
- A new note to Rule 501(a)(8) clarifies that, for purposes of entity look-through rules, if the equity owner of any entity is another entity (and not a natural person), a fund sponsor may keep looking through all the entity layers until reaching a natural person.
- Finally, the amendments also expand the definition of "qualified institutional buyer" in Rule 144A to include limited liability companies and RBICs if such entities meet the US$100 million threshold (in securities owned and invested threshold) otherwise set forth in Rule 144A. The amendments also add to the list any institutional investors included in the accredited investor definition that are not otherwise enumerated in the definition of "qualified institutional buyer," provided they satisfy the US$100 million threshold.

Notably, while commenters suggested that the SEC take additional actions with respect to the "accredited investor" definition, the SEC expressly declined to adjust the existing financial thresholds for inflation, incorporate geographic-specific financial thresholds, or extend the definition to all investors advised by a registered investment adviser or a registered broker-dealer.

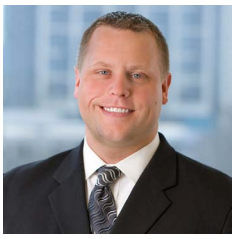
Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta *
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices
Legal Services Centre: Berlin

Contributors

Kevin Lees
Corporate Funds Area Operations Manager, Washington, D.C.
T +1 202 637 5432
kevin.lees@hoganlovells.com

Olesya Barsukova-Bakar
Partner, Washington, D.C.
T +1 202 637 6841
olesya.bakar@hoganlovells.com



Adam Brown
Partner, Northern Virginia
T +1 703 610 6140
adam.brown@hoganlovells.com

Henry Kahn
Partner, Baltimore, Washington, D.C.
T +1 410 659 2780 (Baltimore)
T +1 202 637 3616 (Washington, D.C.)
henry.kahn@hoganlovells.com

Bryan Ricapito
Partner, Washington, D.C.
T +1 202 637 5481
bryan.ricapito@hoganlovells.com

David Winter
Partner, Washington, D.C.
T +1 202 637 6511
david.winter@hoganlovells.com

www.hoganlovells.com