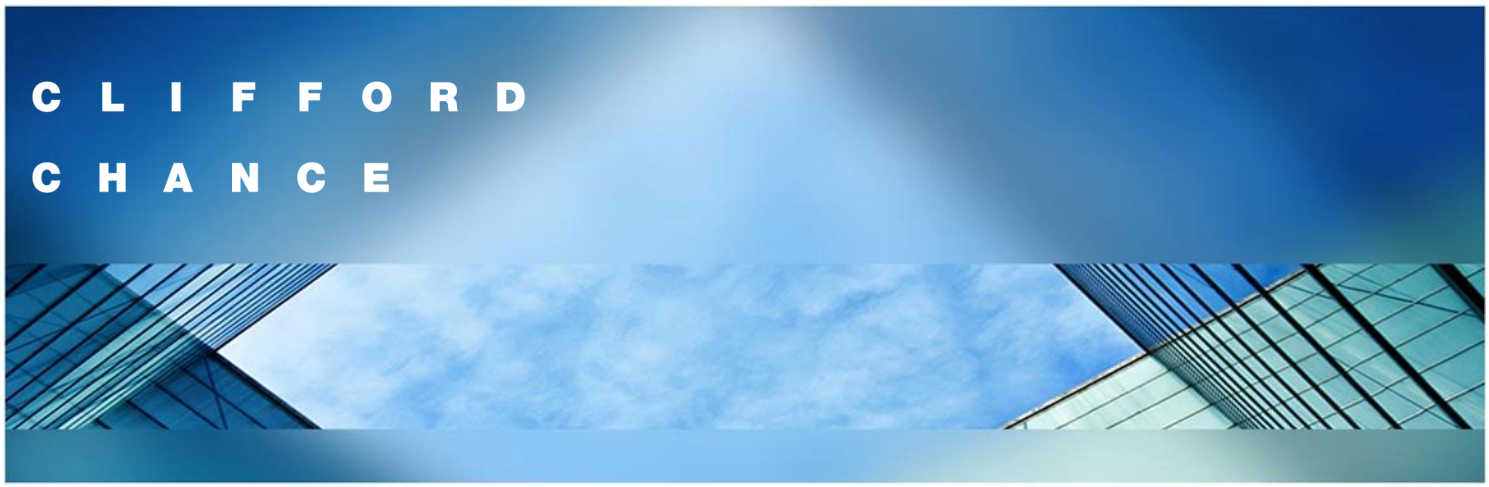

SEC 'ACCREDITED INVESTOR' REVISIONS TO BECOME EFFECTIVE IN DECEMBER; CHANGES EXPECTED TO WIDEN ACCESS TO PRIVATE OFFERINGS

In August, the U.S. Securities and Exchange Commission (the "**SEC**") issued a final rule (the "Final Rule") adopting amendments to the definition of "accredited investor" ("**AI**") in Rule 501(a) of Regulation D under the Securities Act of 1933, as amended (the "**Securities Act**"). Specifically, the SEC added several new categories of individual and institutional investors that would qualify as AIs and made certain other modifications to the existing rule. Additionally, the SEC adopted amendments to Rule 144A under the Securities Act to better harmonize the definition of "qualified institutional buyers" ("**QIBs**") thereunder with the revised AI definition under Regulation D. The Final Rule will become effective on December 8, 2020.

This briefing offers a summary of the new changes, as well as a discussion of key considerations for private fund managers. We believe that the designation of "knowledgeable employees" of private funds as AIs could enable private fund managers to expand the involvement of certain employees that would not have not otherwise qualified under one of the existing AI tests in their fund offerings, as well as generally increase the sources of capital available for private fund offerings. However, we expect the overall impact on the private funds market to be relatively limited, as we describe in more detail below.

NEW CATEGORIES OF ACCREDITED INVESTORS

The SEC has historically viewed wealth-a certain level of income or net worth-as a proxy for financial sophistication, and thus made it the key determinant of an investor's AI status. However, in recent years, the agency has recognized that investor sophistication can be inferred by other indicia, such as the ability of the investor to properly assess and evaluate an investment decision or to bear the risk of loss. Accordingly, in the Final Rule, the SEC has designated as AIs several new categories of both individual and institutional investors that it believes demonstrate these and/or related characteristics.

Individual AIs

- Individuals holding certain FINRA licenses – Individuals holding the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), or the Investment Adviser Representative license (Series 65)[1] in good standing will qualify as AIs.
    - The Final Rule gives the SEC the flexibility to designate by order (after notice and opportunity for public comment) additional certifications, designations, or credentials to qualify an individual as an AI.[2]
- "Knowledgeable employees" of private funds – "Knowledgeable employees" ("**KEs**") (as defined under the Investment Company Act of 1940, as amended (the "**Investment Company Act**")[3]) of a private fund now qualify as AIs for investments in that fund (and other funds managed by their employer). For 3(c)(7) funds, this ensures that all KEs of the fund will be able to invest in the fund. While the definition itself speaks to employees of the private fund, the SEC generally considers certain employees of the fund's manager to be within the category of KEs (because they are "affiliated management persons" of the fund).
    - The Final Rule also provides that a KE's status as an AI will be attributed to their spouse with respect to joint investments made by the KE and their spouse in the private fund.

Notably, the SEC considered, but ultimately decided against, adjusting the individual income and net worth thresholds to reflect the impact of inflation since 1982 (the year in which the initial levels were set).

Institutional AIs

- Registered investment advisers ("**RIAs**") – RIAs (including sole proprietorships), whether SEC or state-registered, will qualify as AIs.
- Exempt reporting advisers ("**ERAs**") – Advisers qualifying as ERAs under Section 203(m) or Section 203(l) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), will qualify as AIs.
- Rural Business Investment Companies ("**RBICs**") – RBICs will be treated as the same as Small Business Investment Companies, which are already designated as AIs.

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1 U.S. Securities and Exchange Commission, Release No. 33-10823 (August 26, 2020).

2 The SEC will consider the following: (i) whether the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution; (ii) whether the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing; (iii) whether persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and (iv) whether an indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verifiable.

3 Rule 3c-5(a)(4) under the Investment Company Act defines a "knowledgeable employee" with respect to a private fund 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 the private fund; and (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.

- Limited Liability Companies ("**LLCs**") – The SEC has codified the SEC Staff's long-standing position that, similar to other entities, LLCs qualify as AIs if they (i) have total assets in excess of $5 million and (ii) were not formed for the purpose of acquiring the securities being offered.
- Other entities with over $5 million in "investments" – An entity qualifies as an AI if it (i) owns "investments" (as defined in Rule 2a51-1(b) under the Investment Company Act) in excess of $5 million and (ii) was not formed for the purpose of acquiring the securities being offered.
- Certain family offices and family clients – A family office (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act (the "**Family Office Rule**")) will qualify as an AI if (i) it has at least $5 million in assets under management, (ii) it was not formed for the specific purpose of acquiring the securities offered, and (iii) its prospective investment is directed by a person who has 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. A "family client" (as defined in the Family Office Rule) of a qualifying family office will also qualify as an AI where a prospective investment in an issuer is directed by that family office.

TRADITIONAL INCOME AND NET WORTH TESTS: CLARIFICATIONS

In the Final Rule, the SEC also adopted amendments clarifying certain matters related to Rule 501(a)(5) (the net worth test for AI qualification) and Rule 501(a)(6) (the income test for AI qualification). Specifically, the SEC established that –

- natural persons who are "spousal equivalents" (defined as "cohabitant[s] occupying a relationship generally equivalent to that of a spouse") will now be able to pool their finances for purposes of calculating joint income under Rule 501(a)(6) and determining net worth under Rule 501(a)(5);
- "joint net worth" can be the aggregate net worth of an investor and their spouse (or spousal equivalent), and assets do *not* need to be held jointly to be included in the calculation; and
- securities purchased in reliance on the "joint net worth" test do not need to be purchased jointly.

PERMITTING ENTITY OWNERSHIP LOOK-THROUGH TO NATURAL PERSONS

The SEC clarified that, in determining AI status under Rule 501(a)(8), it is appropriate to look through various forms of equity ownership to *natural persons* in those cases where the equity owner of an entity itself is an entity, but the owner-entity does not qualify as an AI (such as when it does not meet the $5 million-in-assets test). If such natural persons are AIs, and all other equity owners are AIs, Rule 501(a)(8) may be available.

EXPANDING "QUALIFIED INSTITUTIONAL BUYERS" UNDER RULE 144A

Furthermore, the Final Rule amends Rule 144A to qualify as QIBs (i) LLCs and RBICs, if they meet the threshold of $100 million in securities owned and invested, and (ii) any institutional investors included in the amended AI definition that are not otherwise

enumerated in the QIB definition, provided that they satisfy the $100 million threshold (and such entities may be formed for the purpose of acquiring the 144A securities).

KEY TAKEAWAYS FOR PRIVATE FUND MANAGERS

In general, we expect that these amendments will have a relatively limited impact on the private funds market. Many of the individuals and entities newly designated as AIs may have already qualified based on the income and net worth tests. Furthermore, given that many of the new categories are not based on an individual's finances, we would not expect newly qualified individuals to make large investments comparable to those qualifying as AIs under the traditional income and net worth tests. Additionally, non-KE investors in 3(c)(7) funds would still need to meet one of the "qualified purchaser" standards, which most persons newly qualifying as AIs would likely not be able to meet.

However, there may still be opportunity for private fund managers in the new amendments. Therefore, managers should consider the following:

- Managers may be able to now offer new performance incentives to certain additional employees that qualify as KEs (but did not previously meet the AI net worth or income standards) by allowing them the opportunity to invest in sponsored funds (such as through an employee incentive vehicle). With the view that this will align incentives between a fund's investors and employees, fund investors may take a positive view of managers who take such a step.
- Managers conducting fundraisings in the coming months will need to update their subscription agreements and other applicable documents to appropriately reflect the new changes to the AI and QIB definitions.
- While most family offices probably qualify as AIs under the existing definition, the new amendments are intended to provide clarity for issuers as to their AI status. Although the amendments add additional requirements beyond the asset test that family offices must now meet, the SEC has indicated that issuers can simply obtain a representation in an investor questionnaire (such as that included in a subscription agreement) that the family office meets such requirements.
- The amendments now qualify family clients who are part of a family office. Such individuals who were previously unable to qualify based on the income or net worth thresholds are now potential new investors in Rule 506 offerings (subject to other investor restrictions applicable to the fund).
- Rule 501(a)(8) allows a small private fund (with assets of $5 million or less) to qualify as an AI if all the fund's equity owners are AIs. With the expansion of the AI designation to KEs, certain small funds may now be able to invest in Rule 506 offerings (subject to other investor restrictions applicable to the fund).
- Although most likely already qualify as AIs under the applicable asset test, small RIAs and ERAs (those with assets of $5 million or less) are now eligible to invest in Rule 506 offerings (subject to other investor restrictions applicable to the fund).
- The expansion of QIBs could potentially make it easier to conduct private resales of restricted securities (such as those sold under Rule 506) and, accordingly, reduce the liquidity discount associated with such securities.

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