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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: New SEC Accredited Investor Categories and Rule 144A Amendments

The “accredited investor” definition largely has been unchanged since 1982, but on August 26, 2020, the Securities and Exchange Commission (the “SEC”) adopted amendments to expand the definition in Rules 215 and 501(a) of Regulation D under the Securities Act of 1933 (the “Securities Act”). To conform with these changes, the SEC also expanded the definition of “qualified institutional buyer” (or “QIB”) in Rule 144A under the Securities Act. The amendments become effective 60 days after publication in the Federal Register (which has not yet occurred).

Clients should consider updating their funds’ subscription materials to incorporate the expanded “accredited investor” definition. The changes will have little benefit, though, for private funds that require all investors to be “qualified purchasers” or “qualified clients.” These requirements apply to 3(c)(7) funds and other funds that charge performance-based fees or special profit allocations. The higher “investments” and net worth tests required to meet those definitions will continue to restrict newly-eligible investors under the new “accredited investor” standard.

“Accredited Investor” Amendments Relating to Natural Persons

The amendments expand the accredited investor definition to include the following additional categories of eligible *natural persons*:

Credentialed Investors

Before the amendments, the accredited investor definition primarily relied on 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.” This assessment will be made by the SEC and based in large part on possessing certain credentials that the SEC will identify. In conjunction with adopting the amendments, the SEC designated holders in good standing of the Series 7, Series 65 and Series 82 licenses as natural persons qualifying as accredited investors. The SEC may decide that future certifications and designations will also qualify as accredited investors. Before issuing any such order, the SEC will provide notice and an opportunity for public comment.

Knowledgeable Employees of Private Funds

Rule 3c-5(a)(4) of the Investment Company Act of 1940 defines “knowledgeable employees” to include employees of a private fund or its affiliated management entities who have

participated in the investment activities of such fund (other than in a clerical, secretarial, or administrative capacity) for at least one year, or are currently participating in the investment activities of the fund and have at least one year of similar experience at another company. Pursuant to the Investment Company Act, knowledgeable employees have long been permitted to invest in a private fund without being counted for purposes of the 100-person limit in Section 3(c)(1) or regardless of whether the knowledgeable employee is a “qualified purchaser” for purposes of Section 3(c)(7). Under the amendments, knowledgeable employees of 3(c)(1) and 3(c)(7) funds and their affiliated management entities also will qualify as accredited investors for purposes of offerings made by the funds. The amendments further provide 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

Before the amendments, an individual could qualify as an accredited investor if the individual and his or her spouse, in the aggregate, had a joint annual income over \$300,000 or a joint net worth over \$1 million. The amendments now allow an individual to aggregate his or her income with his or her “spousal equivalent.” Spousal equivalent is defined as a cohabitant occupying a relationship generally equal to that of a spouse. The amendments also clarify 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.

“Accredited Investor” Amendments Relating to Entities

The amendments also expand the definitions of accredited investor for *entities* to include the following new categories:

Registered Investment Advisers (RIAs) and Exempt Reporting Advisers (ERAs)

Accredited investor now includes SEC-registered or state-registered investment advisers, as well as ERAs.

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. Similar to small business investment companies (SBICs), which already qualify as accredited investors, RBICs are intended to promote economic development and the creation of wealth and job opportunities in rural areas and among individuals living in such areas. The amendments add RBICs to the list of entities qualifying as accredited investors, so that RBICs and SBICs are now treated similarly.

Limited Liability Companies (LLCs)

Rule 501(a)(3) lists various types of entities that qualify as accredited investors if they have total assets in excess of \$5 million, but LLCs were left off the list. Despite the omission, the SEC staff has long taken the position that LLCs can be accredited investors if they otherwise meet these Rule 501(a)(3) conditions. The amendments now explicitly incorporate this position into the Rule.

Family Offices

A “family office” is defined in Rule 202(a)(11)(G)-1 under the Advisers Act. The accredited investor definition will now include family offices 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

A “family client” is defined in Rule 202(a)(11)(G)-1 under the Advisers Act. Family clients of family offices (described above) will now be accredited investors so long as the family office meets the definition of an accredited investor.

Entities Meeting an Investments-Owned Test

The amendments allow 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” (as defined in Rule 2a51-1(b) under the Investment Company Act) that exceed \$5 million. The SEC intended to capture (among other entities) Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country.

Entities in Which All Owners Are Accredited Investors

Under Rule 501(a)(8), an entity qualifies as an accredited investor if all of its equity owners are accredited investors. However, this Rule’s application has proved uncertain in instances where an entity’s equity owner is another entity. Amendments to Rule 501(a)(8) clarify that, in determining accredited investor status under that Rule, one may look through various forms of equity ownership to natural persons.

QIB Amendments

Rule 144A under the Securities Act provides a nonexclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain restricted securities to QIBs. Rule 144A’s current definition of a QIB includes a limited set of entities that own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with such person or entity. Similar to the expansion of the accredited investor definition, the amendments expand the QIB definition by providing for additional entities that qualify as QIBs. Specifically, RBICs and LLCs qualify as QIBs if they own and invest at least \$100 million on a discretionary basis. Also now qualifying as a QIB is any institution not already enumerated in the QIB definition that is an accredited investor and meets the \$100 million threshold. The amendments also state that an entity can qualify as a QIB even if it was formed for the purpose of acquiring 144A securities.

This letter is not intended as specific or complete advice and is subject to change. For further assistance, please contact one of the attorneys in the Investment Funds & Advisers group at Shartsis: John Broadhurst, Geoffrey Haynes, Carolyn Reiser, Jahan Raissi, Neil Koren, Jim Frolik,

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