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# Expanding Investment Opportunities: The SEC's Updated Definition of an Accredited Investor

January 2021 • [Michael Davidson](#)

On December 8, 2020, the U.S. Securities and Exchange Commission (the “SEC”) amended and modernized the definition of an “accredited investor” in Rules 215 and 501(a) of Regulation D, promulgated under the Securities Act of 1933 (the “Securities Act”). These amendments expand the definition and will generally increase the number of potential accredited investors. This is a positive change that should lead to greater investment overall, but an understanding of the amendments is necessary to take advantage of the expanded definition.

## Background

The SEC has promulgated numerous rules that define who can, and who cannot, participate in investment opportunities that are not registered under the Securities Act, which includes many investments in private companies and ‘friends and family’ offerings by private investment companies. In order to participate in these securities offerings, a potential investor generally must qualify as an “accredited investor.” For individuals, the most common way to be an “accredited investor has traditionally been to either (i) have a net worth of \$1,000,000 or (ii) have received an annual income of at least \$200,000 for the last two years (or \$300,000 for a married couple). Certain entities could also qualify as an accredited investor if the entity had assets exceeding \$1,000,000.

Over the past several years, the accredited investor definition has been criticized on the basis that its sole focus on an asset/income test has unfairly excluded all but the wealthiest people from lucrative investment opportunities. In response, the SEC began considering ways to expand this definition. After an extensive comment period, the SEC adopted these amendments as a means both to capture individuals that have reliable, alternative indicators of financial sophistication and to modernize certain outdated portions of the definition.

## Amendments to the Definition of Accredited Investor

The amendments substantially change the accredited investor definition by adding new categories of qualifying investors and updating existing investor categories.

### Knowledgeable Employees of Private Investment Companies

“Knowledgeable employees” now qualify as accredited investors. Knowledgeable employees include (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of a private investment company, and (ii) company employees at a private investment company (other than an employee performing solely clerical, secretarial, or administrative functions) who either oversee the private investment company’s investments or who, in connection with their regular duties, have been involved in the private investment company’s investment activities for at least twelve months.

While this definition broadly covers all the executive employees of a private investment company, it only includes certain non-executive employees. The SEC’s primary concern in its regulation of unregistered securities offerings is the protection of those investors that lack a sufficient degree of financial sophistication. This concern does not apply to knowledgeable employees because, by the nature of their position, they have sufficient experience and access to financial information to make informed investment decisions. However, not all employees at a private investment company have this financial sophistication. The determining factor is whether a non-executive employee actually participates in the private investment company’s investments, which must be determined on a case-by-case basis.

The addition of knowledgeable employees to the accredited investor definition will also allow more employees to invest in their employer without the private investment company risking its own status as an accredited investor. Under Rule 501(a)(8) of Regulation D, promulgated under the Securities Act, a private investment company with assets of \$5,000,000 or less may qualify as an accredited investor if all of the company’s equity owners are accredited investors. Prior to the amendments, some private investment companies risked losing their accredited investor status if they allowed their employees to invest in the company’s offerings. Under the amended definition, a greater number of private investment company employees will now be

eligible to invest. This not only creates an additional source of capital for the private investment company, but also further aligns the interests of the employee with their employer.

## Professional Certifications

Individuals with certain professional certifications, designations, or credentials that indicate financial sophistication also now qualify as accredited investors without regard to their financial assets. Currently, only individuals holding certain broker or financial advisor licenses (“Series 7, Series 65, and Series 82”) qualify under the definition, but the amendments grant the SEC the ability to include additional certifications, designations, or credentials in the future.

## Expansion of Certain Entities

Certain types of entities have also been added to the definition. This expansion includes the addition of investment advisors, rural business investment companies, and limited liability companies (“LLCs”) as entities eligible to qualify as an accredited investor. The addition of LLCs is likely the most noteworthy addition. When the definition was last updated in 1989, LLCs were relatively rare and were not included as an eligible entity. Since that time, LLCs have become extremely prevalent, and the definition has been modernized to reflect this. Under the amendments, an LLC is considered an accredited investor when (i) it has at least \$5,000,000 in assets and (ii) it has not been formed solely for the specific purpose of acquiring the securities offered. Additionally, as before, LLCs whose members are all themselves accredited investors also qualify as an accredited investor.

Similarly, certain family offices and their clients have been added to the definition. A “family office” is an entity that is established by a family to manage its assets and provide for its future. To ensure that these entities are covered by the definition, the amendments state that a family office will now qualify as an accredited investor when it (i) manages at least \$5,000,000 in assets, (ii) has not been formed specifically for the purpose of acquiring the offered securities, and (iii) is directed by a person who has the financial sophistication to evaluate the merits and risks of the offering.

Finally, a catch-all provision has also been added. This provision states that any entity, such as a Native American tribe or a labor union, may qualify as an accredited investor when it (i) owns certain investments in excess of \$5,000,000 and (ii) has not been specifically formed for the purpose of acquiring the securities being offered.

## Spousal Equivalents

Under the amendments, a natural person may now include the joint income from a “spousal equivalent” when determining whether they meet the accredited investor

income threshold. Previously, the definition stated that a person could join their income with that of their spouse. The amendments expand this rule and now allow an individual to calculate their joint income with their spousal equivalent, which is defined as a “cohabitant occupying a relationship generally equivalent to that of a spouse.” This will allow people in various forms of relationships that are not a marriage (e.g., domestic partners, etc.) to more easily qualify under the definition.

## No Change to Financial Thresholds

While the amendments have expanded the definition beyond the asset test, the pre-existing financial thresholds remain. The SEC requested comments regarding whether the monetary thresholds for the income and asset tests in the definition should be adjusted. These thresholds have been in place since 1982 and have not been adjusted to account for inflation or other factors that have changed in the intervening 38 years. However, the SEC ultimately decided to leave the asset and income thresholds unchanged for now. While inflation has increased the number of investors that qualify under the asset test, according to the SEC, the amount of information that is readily available has also increased. This has generally led to a greater level of sophistication in market participants, which the SEC believes counterbalances the effect of inflation. Further, there have not been widely reported cases of fraud under the current thresholds, so large scale changes were determined unnecessary.

Accordingly, the primary impact of the amendments will be a modest increase in potential investors who are eligible to participate in unregistered offerings that were previously off-limits, making it easier to raise capital through unregistered offerings. Otten Johnson attorneys have many years of experience in helping clients navigate regulatory changes such as these. Please let us know if we can be of assistance.

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