# SEC PROPOSES ACCREDITED INVESTOR AND QUALIFIED INSTITUTIONAL BUYER AMENDMENTS CRITICAL TO EXEMPT PRIVATE PLACEMENTS AND RESALES

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## I. Executive Summary

On December 18, 2019, the U.S. Securities and Exchange Commission ("SEC") proposed amendments to expand the definitions of "Accredited Investors," critical to Regulation D (Rules 501-508), the most popular method of raising capital through private placements exempt from public offering registration under the Securities Act of 1933 (the "Securities Act"); and "Qualified Institutional Buyers," critical to resales pursuant to Securities Act Rule 144A of restricted securities issued in private placements.

## II. Background

We reported earlier this year that the SEC had adopted amendments to Regulation S-K and associated rules and forms in an effort to modernize and simplify the disclosure rules for reporting (public) companies, investment advisors and investment companies (*see* "SEC Adopts Simplified Disclosure Requirements," April 30, 2019) as part of a larger effort to simplify and harmonize the patchwork of disclosure requirements across the entire securities regulatory scheme.

We also reported that the SEC three months later issued a request for public comments on how to harmonize and streamline the exempt-from-registration framework to allow startups, early stage companies and investors readier access to capital and investment opportunities, with special focus on whether the existing limitations on who can invest in certain offerings exempt for registration are too restrictive notwithstanding the SEC's mission of protecting the investing public and unduly choke off access to available capital (*see* "SEC Seeks Public Comment on Revising and Harmonizing Securities Exempt Offering Regime," July 8, 2019) (both prior advisories are available on request to info@kurtinlaw.com).

The proposed changes to the critical "Accredited Investor" and "Qualified Institutional Buyer" definitions follow directly from those two policy initiatives. The proposed amendments and their implications will be reviewed here and included next month in the January 2020 update to our "Raising Capital through Private Placements: Deal Points" white paper (also available on request to info@kurtinlaw.com).

III. The Proposed Amendments to "Accredited Investor" and "Qualified Institutional Buyer Qualification"

a. Accredited Investors

The distinction between potential purchasers of securities who are "Accredited Investors" and those who are not is central to the Regulation D and other exemptions from the registration requirement of Securities Act section 5. The focus of the securities laws is to ensure adequate disclosure by the issuer of the offered securities to prospective purchasers to allow them to make an informed decision about whether to invest. For Securities Act section 5 public offering registration statements, the disclosure requirements, both of financial and accounting information and of qualitative, or unquantifiable, information are extensive. However, "Accredited Investors," defined in Securities Act section 2(a)(15) and Regulation D, Rule 501(a) to include institutions such as banks and insurance companies, large companies and persons who, by reason of their income, net worth, financial sophistication, or "insider" status such as director or officer of the issuer company, are deemed not to need the benefit of the Securities Act's full disclosure scheme. The net worth and net income requirements are relatively modest for anyone who is likely to be a potential private placement investor: at least $1 million in net worth (excluding primary residence) *or* net income of more than $200,000 in each of the two most recent years (or $300,000 including spousal income). The Regulation D, Rule 506 exemption regime is by far the most popular Securities Act exemption from registration, and the "Accredited Investor" definition is carried over into other exemptions' investor qualifications, notably Regulation A, Tier 2 (often called "Reg. A+"). An exempt private placement under Rule 506(b) may be sold without dollar limitation to an unlimited number of Accredited Investors and no more than 35 "sophisticated" but non-accredited investors. Under the more recent Rule 506(c), which allows some degree of public solicitation, unlike Rule 506(b) and most other registration exemption regimes, *only* Accredited Investors may purchase securities.

So the definition of who and what qualifies as an Accredited Investor is critical. The proposed amendments would expand the "Accredited Investor" definition by:

- qualifying natural persons as Accredited Investors by reason of professional certifications such as a Series 7, 65 or 82 broker-dealer license or other educational credentials (in other words, even if the other net worth or net income or insider status qualifications are not met);

- for investments in private funds, including "knowledgeable employees" of the fund (again, irrespective of meeting the other qualifying thresholds);

- including in the list of qualified business entities some limited liability companies ("LLCs"), registered investment advisors and rural business investment companies ("RBICs");

- including any entity (including Native American tribes), owning "investments," as defined in the Investment Company Act, in excess of $5 million and that is not a "blank check" company (one formed for the specific purpose of investing in the offered securities);

- including "family offices" with at least $5 million in assets under management and their "family clients" as those terms are defined in the Investment Advisers Act; and

- adding the term "Spousal Equivalent" to the Accredited Investor definition to allow spousal equivalents to pool their finances for the purposes of Accredited Investor qualification (for example, the net worth or net income qualifications) (the proposed amendments do not affect those monetary thresholds themselves).

b. Qualified Institutional Buyers

Securities sold under most of the Securities Act exemptions, including Regulation D and most of the others reviewed in "Raising Capital," are "Restricted Securities," as defined in Securities Act Rule 144, meaning securities acquired from the issuer or its affiliate in a transaction or chain of transactions not involving a public offering. Restricted Securities cannot be resold unless they are subsequently registered or unless another exemption from registration is available for their resale. Most such resale exemptions are found under Rule 144, which relies on the Securities Act's section 4(1) exemption from registration of securities sold "by a person other than an issuer, underwriter, or dealer." The term "underwriter," defined in Securities Act section 2(a)(11), means someone who purchased the securities with the intention to distribute them to others, like a traditional investment bank underwriter. A person who is not an underwriter can therefore resell Restricted Securities without registering them under section 4(1), and Rule 144

provides a "safe harbor" for doing so. As a general matter, Rule 144(d) provides that Restricted Securities issued by a company that is not a "reporting company" under sections 13 or 15(d) of the Securities and Exchange Act of 1934 (the "Exchange Act"), cannot be resold by the holder until at least one year from their issuance to him has passed (the required holding period is six months in the case of reporting company issuers). Rule 145 provides another set of rules for the resale of Restricted Securities acquired in the course of business combinations such as mergers and acquisitions.

Rule 144 also provides that an exemption for resale of Restricted Securities is also available for holders to "Qualified Institutional Buyers" as defined in Rule 144A. Qualified Institutional Buyers, or "QIBs," are deemed, much like Accredited Investor purchasers in the case of original issuance of securities, sufficiently sophisticated so as not to need the protections provided by the full registration process of Securities Act section 5 upon resale purchase of those securities. QIBs include insurance companies, investment companies and small business investment companies, investment advisors, employee benefit plans, trust funds, securities dealers registered under section 15 of the Exchange Act and banks. QIBs generally must own and invest on a discretionary basis an aggregate basis at least $100 million in the securities of issuers unaffiliated with them (or, in the case of registered securities dealers, at least $10 million, or be acting in a "riskless principal transaction" on behalf of a QIB). For banks, there is an additional $25 million audited net worth requirement for QIB status.

The proposed amendments would expand the "Qualified Institutional Buyer" definition by:

- as with the Accredited Investor proposal, adding LLCs and RBICs to the types of entities eligible for Qualified Institutional Buyer status if they meet $100 million securities ownership and investment thresholds; and

- establishing a Qualified Institutional Buyer "catch-all" category that would permit institutional Accredited Investors as defined in Rule 501(a) to the extent not already included under Rule 144A to qualify as Qualified Institutional Buyers when they satisfy the $100 million threshold.

## IV. Takeaways and Conclusion

In its June "concept release," the SEC sought public comments on whether the current limitations on who may invest in exempt offerings, and how much they may invest, provide an appropriate balance of investor protection or pose an undue obstacle to capital formation by companies or investor access to investment opportunities, including the qualifications for persons and companies to fall within the "Accredited Investor" definition of Securities Act Section 2(a)(15) and Regulation D, Rule 501(a). The proposed expansions of the Accredited Investor and Qualified Institutional Buyer qualifications will increase the possibilities for raising capital available for investors, not only by qualifying a wider range of persons and entities as Accredited Investors, particularly important for Regulation D, Rules 506(b) and (c), but by facilitating the resale of the Restricted Securities thereby purchased, adding liquidity to the investments that potential investors are considering.

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