

SEC expands ‘accredited investor’ and ‘qualified institutional buyer’ definitions to broaden investor access to U.S. private placements

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On August 26, 2020, the U.S. Securities and Exchange Commission (the SEC) issued final rules amending the definitions of “accredited investor” in Regulation D under the U.S. Securities Act of 1933 (the U.S. Securities Act) and “qualified institutional buyer” in Rule 144A under the U.S. Securities Act. The amendments expand the categories of individuals and entities that the SEC deems to have sufficient knowledge and experience to participate in U.S. private placements without the protections of the SEC’s securities registration process. Notably, the SEC chose not to index for inflation the wealth thresholds for accredited investor eligibility, which will remain the same as they were when Regulation D was introduced in 1982.^[1]

Accredited investor amendments

Background

The U.S. Securities Act provides a number of exemptions from its registration requirements for securities offerings, with Regulation D being the most popular. In its final rules release, the SEC estimated that in 2019, approximately US\$1.56 trillion was raised in private placements to accredited investors under Regulation D while SEC-registered public offerings accounted for US\$1.2 trillion of new capital. Generally, private placements under Regulation D limit investor participation to “accredited investors,” the definition of which covers persons or entities that the SEC considers to be financially sophisticated, capable of evaluating the economic risks and merits of a proposed offering without needing the rigorous disclosure and procedural protections of the SEC’s registration process and who are able to sustain the risk of loss of their investment. Prior to the amendments, the accredited investor definition generally included

- institutional investors such as banks, savings or loan associations, registered broker-dealers or investment advisers and registered investment companies;
- private business development companies;
- corporations or similar organizations with total assets of more than US\$5 million, not formed specifically to purchase the offered securities;
- certain related parties of an issuer, such as its directors and executive officers;
- individuals with net worth (or joint net worth with their spouse) of more than US\$1 million (excluding the value of the individual’s primary residence);

- individuals with an annual income of more than US\$200,000 or joint annual income with their spouse of more than US\$300,000 in each of the two most recent years and who reasonably expect the same for the current year;
- trusts with assets of more than US\$5 million, not formed specifically to purchase the offered securities and whose purchase is directed by a sophisticated person; and
- entities made up of equity owners, all of which are accredited investors.

Under the most commonly used rules within the Regulation D exemption, an issuer may offer an unlimited amount of securities to an unlimited number of accredited investors, provided that the issuer also satisfies the other applicable restrictions under Regulation D.

Amendments

With its amendments, the SEC has updated and expanded the accredited investor definition to be more inclusive of investors who have sufficient knowledge and experience to participate in U.S. private placements without the protections of SEC registration of the offered securities, but who may not have met the requirements under the prior definition.

The SEC's amendments add the following persons and entities to the "accredited investor" definition:

- natural persons who hold professional certifications, designations, status or other credentials from an accredited educational institution that the SEC has designated as qualifying an individual for accredited investor status;^[21]
- natural persons who are "knowledgeable employees" (as defined under the Investment Company Act of 1940 (the Investment Company Act)) of private funds, if they are investing in the private fund that is offering the securities;
- SEC- and U.S. state-registered investment advisers;
- investment advisers exempt from registration under the U.S. Investment Advisers Act of 1940 (the Advisers Act);
- rural business investment companies;
- limited liability companies with at least US\$5 million in assets and not formed for the purpose of acquiring the securities offered;
- "family offices" with at least US\$5 million in assets under management, not formed for the purpose of acquiring the securities offered and whose investments are directed by a sophisticated person, and their "family clients" (each as defined under the Advisers Act); and
- any type of entity not already covered by the definition of accredited investor, not formed for the specific purpose of acquiring the securities offered and that owns "investments" (as defined under the Investment Company Act) in excess of US\$5 million.

The amendments also provide that natural persons can combine assets or income of "spousal equivalents" (defined as a cohabitant occupying a relationship generally equivalent to a spouse) for purposes of satisfying the joint net worth or income thresholds.

Qualified institutional buyer amendment

Background

Rule 144A under the U.S. Securities Act is a commonly used resale exemption limited to qualified institutional buyers, which is a category of institutional investor that, with the exception of registered dealers, owns and invests on a discretionary basis at least US\$100 million in securities of issuers that are not affiliated with the institutional investor. Qualified institutional buyers must fit within one of the prescribed types of entities listed in the definition, which generally have been narrower than the list of entities in the accredited investor definition. The definition of qualified institutional investor has, in the past, resulted in some sophisticated institutions that have met the US\$100 million securities ownership threshold being technically excluded from the definition of qualified institutional buyer status and therefore ineligible to participate in Rule 144A offerings.

Amendment

To help address these technical exclusions, the amendments add a provision to the definition of qualified institutional buyer to include any institution that is not already specifically listed in the definition of qualified institutional buyer but qualifies as an accredited investor and meets the US\$100 million securities ownership threshold. However, unlike in the accredited investor definition, these entities are permitted to be formed as qualified institutional buyers specifically for the purpose of acquiring the securities offered.

Implications for Canadian issuers

Many Canadian issuers raise capital in the United States in reliance on the Regulation D and the Rule 144A private placement exemptions. The SEC's amendments to the definitions of accredited investor and qualified institutional buyer, while not radically expanding the class of either category of investor, will help to broaden the pool from which Canadian companies can raise U.S. capital. The expanded definitions will also help to resolve some of the technical exclusions that certain Canadian institutional investors have confronted when assessing their eligibility to participate in offerings limited to accredited investors or qualified institutional investors. It is not yet clear whether, or to what extent, similar changes may be adopted in Canada to the Canadian accredited investor definition.

Implementation date

The amendments will become effective 60 days after their publication in the U.S. federal register.

[1] A number of commenters and two dissenting SEC commissioners were concerned that the existing wealth thresholds do not provide enough protection for investors who may qualify based on income or net worth, but may be susceptible to fraudulent Regulation D offerings. In the end, a majority of SEC commissioners determined that no available information indicates that incidents of fraud in the private markets are driven or affected by

the levels at which the accredited investor definition is currently set. The SEC has indicated that it will continue to monitor the size of the accredited investor pool, the characteristics of individual accredited investors who participate in the private markets, the appropriateness of the income and net worth thresholds, and, to the extent data are available, performance and incidence of fraud in exempt offerings, including in connection with the SEC's quadrennial review of the accredited investor definition required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[2] Concurrently with its release of the final rules, the SEC issued an order designating the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82) and the Investment Adviser Representative license (Series 65) as qualifying natural persons for accredited investor status.