ALERT MEMORANDUM

SEC Proposes Amendments to the Definition of Accredited Investor

December 23, 2019

On December 18, the SEC voted 3-2 along party lines to propose expanding the definition of "accredited investor." AI status is a key requirement for eligibility to participate in private placements under the Securities Act.

The current AI definition uses income and wealth, as well as institutional status, as proxies for sophistication. The proposal maintains these concepts, but introduces more direct standards for determining when individual investors can fend for themselves and forgo Securities Act registration protection, and expands the scope of covered institutions.

We support the proposal, which would allow a wider range of individuals and institutions to access private capital markets. The proposal follows efforts in recent years to reconsider the AI definition, including a broader 2019 SEC concept release exploring ways to simplify, harmonize and improve the exempt offering framework. The SEC indicated that the proposal is an initial step in this direction.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

New York
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

Courtnie G. Drigo
+1 212 225 2274
cdrigo@cgsh.com

Adam Fleisher
+1 212 225 2286
afleisher@cgsh.com

Jamal Fulton
+1 212 225 2988
jfulton@cgsh.com

Maurice R. Gindi
+1 212 225 2826
mgindi@cgsh.com

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

Jeffrey D. Karpf
+1 212 225 2864
jkarpf@cgsh.com

David Lopez
+1 212 225 2632
dlopez@cgsh.com

Marc B. Rotter
+1 212 225 2099
mrotter@cgsh.com

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In brief, the proposed changes include:

— Allowing individuals to qualify as AIs based on professional knowledge, certification or experience, including Series 7, 65 and 82 licenses.

— Treating "knowledgeable employees" of private funds as AIs eligible to invest in the funds.

— Adding a new category of AI covering any entity owning "investments" (not assets) in excess of $5 million, so long as not formed for the purpose of investing in the offered securities.

— Adding "family offices" with at least $5 million of assets under management, and their "family clients," as AIs.

— Reflecting longstanding SEC staff views, adding LLCs to the list of entities eligible to be AIs, as well as "qualified institutional buyers" (QIBs) under Rule 144A.

— Amending Rule 144A to permit institutional AIs with an entity type not already included in the QIB definition to qualify as QIBs, so long as Rule 144A's $100 million threshold for securities owned and invested is satisfied.

Vehicles registered under the Investment Company Act currently can aggregate the amount of securities owned with affiliated investment vehicles for purposes of meeting Rule 144A's $100 million threshold. The proposal touched on this point, but does not appear to extend this treatment to unregistered vehicles, which we think would be beneficial.

The proposal solicited further comment on whether to include as AIs investors advised by financial professionals. We believe this could be a useful addition, particularly where the adviser is acting with discretion on behalf of a non-AI. A similar change to the QIB definition, allowing a QIB, such as an SEC-registered investment adviser, to act on behalf of an entity that is not a QIB – *e.g.,* a newly formed fund that does not yet have $100 million of securities on its balance sheet – would seem even more warranted.

The proposal acknowledges that the expansion of the AI pool could reduce capital allocation to the public markets, further exacerbating a long-term trend: in 2018, Regulation D Rule 506 offerings ($1.7 trillion) exceeded SEC-registered offerings ($1.4 trillion). The proposal seeks to balance the risks private investments present with widening access to potentially higher-returning deals.

Commissioner Jackson dissented from the proposal, raising concerns around the adequacy of expanding eligibility for exempt offerings absent sufficient data on the costs of doing so. In particular, he expressed concerns about the proposal's suggestion that investors using advisers need less protection than others and noted a higher incidence of misconduct by brokers in the private placement market. We believe it would be better to discipline malfeasant brokers than to foreclose private market access for those who carry out their duties appropriately.

Commissioner Lee, who also opposed the proposal, raised concerns about the inadequacy of wealth as a proxy for sophistication, the 27-year old monetary thresholds in the current definition and the proposal's failure to include inflation indexing. The proposal declined to change the current thresholds, noting that they still far exceed mean and median household income and net worth in all regions of the country. The proposal also suggested that instead of imposing an automatic inflation adjustment, the SEC can consider the appropriateness of the thresholds every four years, which the Dodd-Frank Act requires.

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