Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC Leaves Door Open For More Private Market Expansion

By **Tom Zanki**

Law360 (August 28, 2020, 9:12 PM EDT) -- The U.S. Securities and Exchange Commission's long-awaited changes to the definition of an accredited investor appear incremental, but they set the stage for further expansion of already rapidly growing private capital markets where investors have fewer protections.

The SEC's action Wednesday modestly expanded the category of accredited investors, which determines who is eligible to invest in unregistered securities, to add owners of select securities licenses, plus other wealth management firms and "knowledgeable employees" of private funds.

The expansion follows years of widespread criticism that the criteria for an accredited investor are flawed and antiquated. The definition historically has been limited to a person's wealth or income, which determine their ability to bear a loss, without regard to sophistication.

Besides the immediate changes, regulators opened the door for more expansion of the definition in two ways. First, the new rule explicitly invited feedback on how the agency may broaden the list of accredited investors in the future and authorizes the SEC to do so by order.

The agency also opted not to update personal income or wealth thresholds or adjust those figures for inflation going forward, thus enabling more people to enter the category over time. The category of accredited investor is now mostly limited to individuals with $200,000 in annual income or $1 million net worth excluding their home — figures that have been largely untouched since 1982.

The SEC passed the rule 3-2 along party lines, with Democratic commissioners dissenting over concerns about the opacity of private markets and commissioners filling Republican seats favoring the policy for its potential to open a growing market to more investors.

Attorneys that steer private investors and fund managers welcome the rule change, which they expect will lead to the steady expansion of investors able to participate in private markets.

"So long as [SEC Chairman Jay] Clayton is in power, this is totally in line with his policy and agenda in terms of opening up the private markets to a broader swath of investors," Cadwalader Wickersham & Taft LLP partner Dorothy Mehta said.

That trend worries skeptics, who note that unregistered securities expose investors to risks without the disclosures, pricing transparency and investor rights afforded by public markets. Private securities also carry more resale restrictions than stocks that trade on public exchanges.

"In Chairman Clayton's final days, the SEC is continuing its hyperpartisan crusade to exempt people, companies, and industries from the protections of the federal securities laws," said Healthy Markets CEO Tyler Gellasch, whose group represents pension funds and other investors.

The SEC declined to comment Friday. In a statement accompanying his vote on Wednesday, Clayton described the measures as "modest, incremental efforts" to increase investment choices and make it easier for early-stage companies to raise seed capital. He argued that past policy of relying only on wealth to measure eligibility to invest in private offerings was unsound.

"Individual investors who do not meet the wealth tests, but who clearly are financially sophisticated enough to understand the risks of participating in unregistered offerings, are denied the opportunity to invest in our private markets," said Clayton, who was appointed by President Donald Trump to lead the SEC in 2017.

The SEC policy follows decades of explosive growth in private markets, a less regulated corner of the market that has become the dominant source of capital raising in the U.S.

Companies raised $2.7 trillion in unregistered offerings in 2019, totaling 69% of all new capital, compared with $1.2 trillion raised in registered public offerings, according to SEC data.

That seems unlikely to change much, at least in the near term. The SEC did not estimate how many new accredited investors may result from its rule, but the agency expects the total is not "significant" and will have minimal immediate effects on private capital raising.

But wheels appear in motion for a larger population of private investors in the coming years.

The new policy mainly adds holders of Series 7, 65 and 82 licenses, which allow individuals to do things like sell securities or offer investment advice, to the ranks of accredited investors. The 166-page rule also authorizes the SEC to add more credentials as it sees fit in the future.

"While a modest first step, these additions are welcome and a harbinger of bigger things to come," crowdfunding attorney Mark Roderick of Lex Nova Law LLC wrote on a blog Thursday.

Healthy Markets' Gellasch said it's hard to see the SEC denying accredited status to other professionals who can show financial sophistication, such as chartered financial analysts, certified public accountants, or individuals with advanced degrees in business or law. Regardless of personal wealth or sophistication, he said, investors of private securities have less ability to assess their risks.

"No matter how rich you are or how sophisticated you are, if you don't have the information and the rights, you are just gambling," Gellasch said.

The SEC's decision not to adjust personal wealth and income thresholds for inflation is also likely to create more accredited investors over time. When current minimums were set in 1982, about 1.8% of households qualified as accredited investors, compared with about 13% now. The $200,000 annual income and $1 million net worth totals were never adjusted for inflation, though the Dodd-Frank Act removed home value from net-worth sums.

Cohen Milstein Sellers & Toll PLLC partner Laura Posner, a former bureau chief for the New Jersey Bureau of Securities, the state's securities watchdog, cautioned that senior citizens could be vulnerable to a broader accredited investor definition. Seniors tend to have larger retirement accounts from investing during their careers, which they may depend on for living expenses.

Posner cautioned that seniors could be fraud targets since "private placements are one of the most frequent sources of fraud and enforcement actions by both state and federal regulators."

"The left hand is not speaking to the right hand about the risky nature of these types of investments and then expanding the number of people who are available to be defrauded by investing in them," Posner said.

Lawyers who steer private offerings say the SEC's changes to the accredited investor definition are hardly radical, instead arguing that many sophisticated parties want to invest in private securities but were barred by rules that had no rational basis.

Morgan Lewis & Bockius LLP partner Christine Lombardo said the additions to the class of accredited investors "just make plain sense." Aside from holders of certain securities licenses, accredited investors will now include wealth management firms known as "family offices" with at least $5 million in assets, plus people considered "knowledgeable employees" of a private fund.

Native American tribes, governmental bodies, funds and entities organized under laws of foreign countries that own investments of at least $5 million in assets are also now deemed accredited investors.

For clarity's sake, Lombardo would have preferred that the SEC deem "qualified purchasers" — a separate category of individuals that generally own at least $5 million in investments — as accredited investors. The SEC declined, saying in its rule that the two groups serve different functions, though many qualified purchasers likely meet accredited investor status anyway.

"It is a step in the right direction for the industry," Lombardo said of the SEC's rule. "The expansion of the categories all make sense. I do think that it could have gone further."

--Editing by Kelly Duncan and Brian Baresch.