

Regulatory Update

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SEC Proposed Amendment Would Broaden Access to Private Markets

On December 18, 2019, the Securities and Exchange Commission (the “**SEC**”) released a proposed amendment to the definition of an “accredited investor” that would broaden the categories of qualifying persons and entities. The new categories are based on, among other things, professional knowledge, experience and/or certifications. Accredited investor status is important because, under U.S. securities laws, accredited investors may participate in investment opportunities that are generally unavailable to the wider public, including investments in private companies and funds.

“Qualifying as an accredited investor is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds.”

– SEC Release

Regulatory Background

The U.S. securities laws are designed to protect investors by: (i) imposing liability for fraudulent disclosures in the offering and sale of securities and (ii) requiring disclosure to potential investors of all material information known to the issuer. However, where the potential investors maintain “financial sophistication and ability to sustain the risk of loss of investment or fend for themselves,” the protections afforded to investors under U.S. securities laws are deemed to be unnecessary and an issuer may qualify for an exemption from registration.

The most commonly used exemptions from these registration and disclosure requirements are for private securities sales conducted under Rule 506(b) or 506(c) of Regulation D. **For comparison, Regulation D private offerings outraised public offerings by about \$300 billion last year (\$1.7 trillion under Rules 506(b) and 506(c) v. \$1.4 trillion in registered offerings).** Under 506(b), an issuer may raise an unlimited amount of money from an unlimited number of accredited investors and up to 35 non-accredited investors. However, the offering must be truly private in the sense that the issuer may not generally solicit or advertise. Under 506(c), an issuer may raise an unlimited amount of money from an unlimited number of accredited investors and it may advertise the offering, but it must take reasonable steps to verify the accreditation status of each investor in the offering as non-accredited investors are not permitted to participate.

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506(c) v. \$1.4 trillion in registered
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What is an Accredited Investor? What are the New Categories?

The existing categories of accredited investors are based primarily on wealth, which the SEC historically used as a proxy for financial sophistication. It is worth noting that the rationale for protection under U.S. securities laws is largely inapplicable where the investor maintains qualities such as “financial sophistication” and “ability to fend for themselves.” Those qualities are independent from the wealth of a particular investor, so it makes sense that the SEC would modernize the accredited investor definition to better fit within its mandate.

For natural persons, the only ways to qualify as an accredited investor historically were to satisfy either an income requirement (at least \$200,000 individually or \$300,000 jointly with a spouse in gross income for each of the two most recent years) or a net worth requirement (at least \$1 million, individually or with a spouse, excluding the value of a primary residence). Executives and higher ups within the issuer may also qualify. To these existing categories, the SEC is proposing to add qualifications based on the following FINRA examinations:

- Series 7 – Licensed General Securities Representative
- Series 65 – Licensed Investment Adviser
- Series 82 – Licensed Private Securities Offering Representative

In addition, certain “knowledgeable employees” in hedge funds, private equity funds and venture funds will also constitute accredited investors going forward. Similar to existing exemptions for executives within an organization, the “knowledgeable employee” accredited investor will be issuer-specific and not generally applicable to other raises.

For entities, the existing rule generally required that the entity maintain at least \$5 million in total assets. Other entities were classified as “accredited investors” based solely on their type (for example, broker dealers, banks, savings and loans institutions). To these existing categories, the SEC is proposing to add the following entity types:

- Registered investment advisers
- Limited liability companies (note – these were widely understood to be permitted previously, but the proposed rule makes their inclusion abundantly clear)
- Rural business investment companies
- Any entity that owns investments in excess of \$5 million

Note the difference between an entity owning “investments” and an entity maintaining “assets.” Similar to the new natural person additions to the definition of an accredited investor, an “investment” test is more specifically tailored to measure a participating party’s ability to evaluate a primate market transaction.

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Conclusion

The SEC's proposed amendments will broaden the base of accredited investors to more properly include individuals and entities that, despite not meeting the historically mandated wealth requirements, may nevertheless have the knowledge and experience necessary to evaluate the merits and risks of a prospective investment. All proposed amendments are open for public comment for 60 days after it is published in the Federal Register, which means the earliest these changes could take effect are in mid-February.

Parallel Markets is a software company developing the tools to bring liquidity to private investments. Leveraging decades of private market experience, Parallel Markets is building technology from the perspective of actual issuers, employees and investors for use by actual issuers, employees and investors. Securely and accurately asserting identity and accreditation status online is a core piece of the private market's infrastructure, and Parallel Markets believes this will be critically important in developing a future with minimal friction between investor and investment. The Parallel Passport is the tool Parallel Markets developed to provide a universal and portable identity solution for investors online.

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