SEC's Accredited Investor Rule Will Benefit Sovereign Wealth

By Steven Canner, Michelle Heisner and Ava Haghighi (October 6, 2020)

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A proposal by the U.S. Securities and Exchange Commission to amend the definition of "accredited investor" in Rule 501(a) of Regulation D — one of the categories of investor to which an issuer can offer and sell securities that have not been registered under the U.S. Securities Act of 1933 — has made its way into a final rule.[1]

This final rule, which amends the definition of accredited investor and will be effective sometime after Oct. 31, among other things, clarifies the guidance applicable to sovereign wealth funds and other statutorily-created foreign entities at one time provided on a case-by-case basis by the SEC (i.e., by way of no-action letters).

This new rule provides certainty to sovereign wealth funds, which meet the criteria described below, that they would qualify as accredited investors, thereby providing an easier path for certain investment activities by such institutions.

Why does accredited investor status matter?

Qualification as an accredited investor opens up investment opportunities in the U.S. In essence, accredited investors are those individuals and entities that the SEC considers sufficiently sophisticated to invest in the private market, where opportunities do not necessarily meet the levels of liquidity and disclosure that exist for publicly issued stocks and bonds.

What problems have sovereign wealth funds faced to date?

Historically, sovereign wealth funds have not fit neatly into the definition of accredited investor. This is because sovereign wealth funds, as statutory-created foreign entities, were not explicitly listed as one of the entity types under Rule 501(a)(3) of Regulation D, despite often having assets that exceeded the accredited investor threshold of $5 million.

> [A]ccredited investor shall mean ... any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000.[2]

While issuers may have been able to rely on other exemptions from registration when offering and selling securities to sovereign wealth funds, the lack of clarity, arguably, has interfered with, or, at least has been a nuisance to, access to private investment opportunities for sovereign wealth funds.

Other exemptions from registration — such as under Section 4(a)(2) of the Securities Act, which covers certain transactions by an issuer not involving any public offering, and Regulation S, which allows certain offshore transactions by an issuer — each involved their own separate requirements and analysis.

How does the SEC's final rule provide clarity for sovereign wealth funds?

The final rule adds new categories of entities to the accredited investor definition, among which is a catchall category for any entity of a type not already covered by a other paragraphs of the rule that owns investments in excess of $5 million and which was not formed for the specific purpose of acquiring the securities being offered.

This catchall category is intended to formalize the no-action guidance the staff of the SEC previously provided on a case-by-case basis to clarify that certain entities would be considered substantially similar for the entity-based accredited investor test.

Such guidance included a position by way of a 2011 no-action letter that the Alaska Permanent Fund, as a "large sovereign wealth investment fund with a unique form of organization established by name in the constitution of the State of Alaska," was an accredited investor, even though it was not organized as an entity specifically listed under Rule 501(a)(3).[3]

The SEC stated in its adopting release:

> [T]he term "entity" is sufficiently broad in this context to encompass Indian tribes and the divisions and instrumentalities thereof, federal, state, territorial, and local government bodies, funds of the types identified by commenters, and entities organized or under the laws of foreign countries.

What other takeaways are there for sovereign wealth funds from the SEC's adopting release?

There are a few other points that the SEC specifically discussed in its adopting release that sovereign wealth funds should keep in mind when applying the SEC's final rule.

Quantitative Threshold

The SEC has declined to adjust the quantitative threshold of $5 million under the existing rule.

There had been speculation that the SEC might adjust the threshold for inflation and one commenter suggested doubling the threshold to $10 million.[4] But the SEC reiterated its belief that $5 million was the appropriate threshold for sophistication, noting that it was "not persuaded [by the commenter] that setting the threshold at double the amount applicable under the assets test for other institutional accredited investors is warranted in order to illustrate a similar level of financial sophistication."

Investment-Based Test

While the final rule does not increase the $5 million quantitative threshold, it does require an investment-based rather than an asset-based test.

In the SEC's view, an investment-based test better demonstrates "experience in investing and is therefore more likely to have a level of financial sophistication similar to that of other institutional accredited investors."

The SEC noted that an the risk of an asset-based test was that certain types of entities covered by the amendment, such as governmental entities, may have over $5 million in

nonfinancial assets, such as land, buildings and vehicles, but not have any investment experience.

The new test will use the definition of "investments" from Rule 2a51-1(b) under the Investment Company Act. This use of an existing definition is designed to ease application of the rule by potential investors. The SEC states that relying on an existing regulatory framework will "facilitate compliance and alleviate confusion."

Conclusion

Codifying a catchall category for entities in the accredited investor definition is just one of a number of changes made by the SEC's final rule.

Other amendments to the definition have received more attention in the recent days and months — such as those expanding the definition to cover natural persons not only meeting certain monetary thresholds but also those with knowledge of the financial markets, such as licensed brokers or employees of financial institutions.

But for sovereign wealth funds and other entities, this amendment should lay to bed an ongoing headache in their investment activities in the U.S.

Sovereign wealth funds will need to keep in mind that they have a new investment-based test that they will need to satisfy when fitting into the accredited investor definition.

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[1] Amending the "Accredited Investor" Definition, Securities Act Release Nos. 33-10824 & 34-89669, available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf. This release has not yet been published in the Federal Register.

[2] Regulation D, 17 C.F.R. § 230.501(a)(3) (2016).

[3] Alaska Permanent Fund, SEC No-Action Letter (July 14, 2011), https://www.sec.gov/divisions/corpfin/cf-noaction/2011/alaskapermanentfund-071411-501a.htm.

[4] North American Securities Administrators Association, Inc. dated Mar. 16, 2020.