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INVESTOR ACCREDITATION AND QUALIFICATION

The Accredited Investor Definition: Key Takeaways for Private Fund Managers (Part Two of Two)

By Robin L. Barton, *Hedge Fund Law Report*

"An educated consumer is our best customer" was the slogan of the now-defunct clothing store chain SYMS. In the world of private funds, an appropriate spin on that tagline would be, "A financially sophisticated individual is our best investor." In fact, that concept is embedded in the term "accredited investor" – a key element of Rules 506(b) and 506(c) of Regulation D under the Securities Act of 1933 and in other securities-law contexts.

Accredited investors are assumed to be financially sophisticated enough to understand the risks inherent in investing in private offerings, such as hedge and private equity (PE) funds, and thus, to not need the same protections under the securities laws as "retail" or less sophisticated investors. The problem is that the definition of accredited investor is outdated and tied to income and wealth thresholds that arguably do not actually reflect financial acumen.

To address some of those issues, the SEC published proposed changes to the definition of accredited investor (Proposal) in the Federal Register on January 15, 2020. Comments to the Proposal may be submitted through March 16, 2020.

This two-part series examines the proposed amendments to the accredited investor definition and their implications in the private-funds context. This second article discusses the key takeaways from the Proposal for private fund managers. The first article reviewed the key proposed amendments to this important definition and examined the views of the SEC commissioners on the Proposal.

For more on the SEC's efforts to update securities regulation, see our two-part series: "SEC Chair Reviews Efforts to Modernize Regulatory Framework": Part One (Jan. 30, 2020); and Part Two (Feb. 6, 2020).

Natural Persons

According to the press release announcing the Proposal, the proposed amendments "would allow more investors to participate in private offerings" by adding new categories of natural persons who may qualify as accredited investors based on their professional knowledge, experience or certifications. Does the Proposal accomplish this goal in any significant way? Do the managers of hedge funds and PE funds actually want to open their funds to the kinds of investors who could qualify under an expanded definition of accredited investor?

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See "What Do the Investor Advisory Committee's Recommendations Mean for the Future of Marketing of Hedge Funds to Natural Persons?" (Oct. 24, 2014); and "Implications for Hedge Fund Managers of the Rule Amendments Recently Adopted by the SEC to Raise Accredited Investor Standards" (Jan. 5, 2012).

Limited Expansion – and Limited Benefits

"For private funds, the Proposal is a net positive. I don't know, however, that managers trying to launch with more institutional capital bases or existing managers that are growing their capital bases are really going to see material benefits from these changes to the accredited investor definition," said Lowenstein Sandler partner Benjamin Kozinn. "Emerging fund managers may benefit by having a broader pool of capital than they might otherwise have had in the past, allowing them to grow into larger funds and then start attracting more institutional investors because they were able to obtain critical mass through the expansion of this definition." He concluded, "I doubt, though, that these changes are necessarily going to create a massive volume of capital flows."

"The changes are fairly modest and not revolutionary or dramatic in any way. To some degree, they do level the playing field for small businesses, including small fund managers," observed Kay Gordon, partner at Nelson Mullins. "It's definitely a good thing for private funds in the sense that private funds need access to capital and are often concerned with bringing in new investors." She agreed that newly formed funds and emerging managers are more likely to benefit from the Proposal than established managers.

Maurice Gindi, partner at Cleary Gottlieb, also agreed that the Proposal "moves the needle on the margins for private funds but really is not a significant game changer. It's probably more impactful for emerging managers."

See "Emerging Managers Need Appropriate Infrastructure – Not Only Solid Performance – To Attract Investors" (Jun. 20, 2019).

Downsides to Expansion

Expanding the pool of individuals who would qualify as accredited investors may also have some downsides for some private fund managers. For example, Gordon noted that the expanded definition could increase competition in the private funds space by helping emerging managers. "Established fund managers may not like having more managers out there – or they might not care. Competition is good, however, because it makes people think harder, work harder and be more efficient, ultimately benefitting investors," she added.

"There is some overarching concern that individuals who qualify under the new definition still may not understand the products in which they may be investing. Private fund managers don't want fickle money," explained Kozinn. "They want investors who truly understand not only their investment strategies, but also their visions for their funds and the risks associated with those visions."

"If the returns don't look as good as or align with what they thought they should be getting, investors in private funds who don't have the necessary level of financial sophistication are more likely to redeem more quickly, make claims to a regulator or file lawsuits," warned Kozinn.

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"Having a large number of smaller investors also creates administrative and operational issues for private fund managers. Many managers don't want a lot of investors putting $20,000, $30,000 or $100,000 into the fund. Every time you add an investor, it triggers reporting requirements and creates tax, operational and compliance issues," continued Kozinn. "A higher volume of smaller checks adds costs and complexity."

Gordon agreed, remarking that "for a variety of reasons, it often is more of a headache for a private fund manager to have a lot of smaller investors rather than a few larger ones."

For additional insights from Gordon, see our two-part series "Why and How Do Hedge Fund Managers Set Minimum Subscription Amounts?": Part One (Jun. 6, 2013); and Part Two (Jun. 13, 2013).

Income and Wealth Thresholds

Notably, the Proposal does not include changes to the income and wealth thresholds that individuals must meet to qualify as accredited investors. Under the existing definition, a natural person is an accredited investor if he or she satisfies the following bright-line income or net worth tests:

- individual income exceeded $200,000, or joint income with his or her spouse exceeded $300,000, in each of the two most recent years, and he or she has a reasonable expectation of reaching the same income level in the current year; or
- individual net worth, or joint net worth with his or her spouse, exceeds $1,000,000 (excluding the value of his or her primary residence).

"Although the SEC retained these thresholds, it is acknowledging that wealth is a pretty crude proxy for sophistication generally," observed Gindi. "That's a positive development."

"Those dollar thresholds have existed for decades, but I'm not sure that the figures necessarily equate to an understanding of financial products. In some respects, those numbers are somewhat arbitrary," added Kozinn. "Having a lot of income does not necessarily equate to sophistication with complex financial products."

"Of course, you have to engage in a line-drawing exercise at some point," Kozinn conceded. "For example, switching to some sort of principles-based test would be very hard not only to monitor but also to implement for the issuer, whether that be a private company or a private fund."

Gordon acknowledged that the existing thresholds don't necessarily reflect investors' financial sophistication, but she noted that they are an established standard with which fund managers are already familiar. "In addition, in certain markets, such as the Midwest or South, raising those standards would have a somewhat more dramatic effect. There may be fewer issuers in some of those regions, but there are also fewer accredited investors," she commented. "In truth, people with identical earnings or wealth in those markets may actually have relatively more buying capacity and more capital than their peers in the Northeast."

See "SEC Commissioners and Staff Discuss Possible Amendments to Definition of Accredited Investor" (Jun. 2, 2016).

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Knowledgeable Employees

The section of the Proposal with the most direct impact on private fund managers is the proposed expansion of accredited investor to include "knowledgeable employees" of private funds. That proposed new category would adopt the definition of knowledgeable employee in Rule 3c-5(a)(4) under the Investment Company Act of 1940.

"Executive officers and directors are already effectively permitted to invest in their private funds. The Proposal simply aligns the accredited investor standard with the qualified purchaser standard for knowledgeable employees," explained Gordon. "Giving the portfolio managers and other fund manager employees who are managing money or otherwise contributing to that management the opportunity to invest alongside third-party investors is a good thing." She added, "The employees will work harder and are more incentivized on behalf of the other investors and themselves. Outside investors feel better when the fund principals and those who manage their money are in it to win it. It's called alignment of interests."

Gindi also noted that investors will benefit from allowing knowledgeable employees to invest in their own funds. "In my negotiations with investors in private funds, one of the most significant points of discussion is the 'skin-in-the-game' element. Investors are really diving deep into not only how much is being invested by the firm, but also who is making that investment," he observed. "Is it just the founders, who have significant capital, or is it the deal team members and the employees on the ground who make the investment decisions?"

See "AIMA Survey Examines Evolution in the Ways That Managers Align With Investors" (Nov. 7, 2019).

Although Gindi agreed that the knowledgeable employee provision was beneficial for private fund managers, he did not believe it was going to result in significant amounts of capital for those funds. "We have had situations in which a client's employees who are actively involved in the fund's investments are knowledgeable employees but not accredited investors, so they aren't able to invest in the fund," he noted. "The Proposal would correct that unfortunate and illogical scenario."

"Working at a hedge fund, however, doesn't necessarily mean that you are financially sophisticated and understand the product that's being offered and the risks of that product," observed Kozinn. "It's somewhat of a philosophical decision by the founders as to who they believe are really 'knowledgeable' employees."

"Many managers may go the other extreme and require any employee who is considered knowledgeable to put money into the fund because they want to be able to tell investors that the fund has alignment across the platform with the investors," continued Kozinn. "There are definitely going to be managers that will expand access to their employees – not because it's going to necessarily bring in a horde of new capital but because it's better marketing." He noted that "employees may not be reaching directly into their pockets to put capital into the fund. Rather, all or part of their bonuses may be invested in the fund. This also gives managers another employee-retention and acquisition tool."

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See "Ways Fund Managers Can Compensate and Incentivize Partners and Top Performers" (Dec. 14, 2017); and "SEC Clarifies Scope of the 'Knowledgeable Employee' Exception for Section 3(c)(1) and 3(c)(7) Funds" (Feb. 28, 2014).

Entities

Although the expansion of the natural persons who qualify as accredited investors may not greatly increase the pool of potential investors in private funds, the expansion of the entities qualifying as accredited investors may have a somewhat bigger impact – particularly the inclusion of "Indian tribes."

"The Native American tribes definitely have access to significant amounts of capital, especially in light of all the casinos that they have built over the last 20 years, so they could become a new source of 'institutional' capital for private fund advisers," remarked Kozinn. "It would be great if Native American tribes became a new class of investors much like pension funds, but I do not think it would change the tilt of the earth for private funds."

Although Gindi agreed that specifically allowing Indian tribes to have access to private funds is a positive development, he noted that the proposed change is merely a technical one. "There are already ways for an Indian tribe to invest in private funds by forming a corporation or partnership," he explained. "So, it's actually more of an administrative change. I don't see it as a real game changer."

"I find it puzzling that the SEC made a distinction for different types of entities. For partnerships, corporations and certain other entities, the standard is based on $5 million in assets, but for the new 'other' types of entities catchall, the standard would be based on $5 million in investments," commented Gindi. "I don't necessarily agree with the arguments set forth by the SEC for that distinction. It creates complexity and is likely going to create more confusion than anything. There should be a single standard."

Qualified Institutional Buyers

The Proposal also included potential changes to the "qualified institutional buyer" (QIB) definition in Rule 144A that would, among other things, add a catchall category that would permit institutional accredited investors under Rule 501(a) of an entity type not already included in the QIB definition to qualify as QIBs if they, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers.

Gindi said that he believes that the SEC should adopt other changes, such as looking to the QIB status of a fund's adviser or aggregating securities held by affiliated investment vehicles, which would be even more helpful.

For a case involving QIBs, see "Federal District Court Dismisses Hedge Funds' Complaint Against PXRE Group for Federal Securities Laws Violations in Private Placement Offering" (Feb. 11, 2010).

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Qualified Purchaser and Qualified Client Definitions

None of the attorneys the Hedge Fund Law Report spoke to were surprised that the Proposal does not address the qualified purchaser and qualified client definitions – although they do expect the SEC to address those terms later.

"I don't believe that the SEC missed an opportunity to address the definitions of qualified client and qualified purchaser, because they have different purposes and have distinct policy objectives behind them," said Kozinn. Gordon agreed, adding that "the qualified client standard is pretty limited in the sense of what it does."

Gindi would welcome updates to the qualified purchaser and qualified client definitions. "Changes to those terms would have a more substantial impact on the private funds industry," he remarked.

See "SEC Order Increasing the Dollar Threshold for 'Qualified Client' Status Further Chips Away at the Utility of the 3(c)(1) Fund Structure" (Aug. 19, 2011).

Final Thoughts

At the heart of the accredited investor definition is the goal of protecting investors from making risky investments they do not fully understand and experiencing losses they are ill-equipped to bear. The risks of investing in private funds may be overstated, however.

"Some private funds provide less risk than, for example, a direct investment in an issuer because they are diversified," added Kozinn. "They also have professional managers who oversee those risks; have experience in the types of industries and companies in which they're investing; and have an overall fiduciary duty to the investors and the fund."

"Yes, we should protect investors, but we don't want to be too paternalistic, either. There are risks in those sorts of products, but there are better ways to manage those risks than not allowing investors to participate in private funds at all," commented Gindi. "By denying certain investors access to private funds, you are also denying them the possibility of participating in the upside, which could be even more damaging."

There are other ways to protect vulnerable investors, continued Gindi. For example, he said that he supports the option floated in the Proposal that individuals who do not meet the income or asset thresholds still be able to invest in private funds if they are advised by registered investment advisers.

"Of course, there is the risk that folks could be victimized by unscrupulous advisers, but I don't think we should always regulate to the lowest common denominator. We should give people the ability to take advantage of and benefit from the expertise of others," argued Gindi. "Another interesting proposal would be to allow individuals to invest in a private fund as long as there is a significant amount of institutional or other more sophisticated capital also invested in that fund, thereby acting as a market check."

The stated goals of the Proposal are to promote capital formation and expand investment opportunities for more people.

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"Many people have made a lot of money over the last ten years investing in private issuers and private funds. Many private companies are not going public for a very long time – or at all. Investors that had access to those companies have made enormous returns," acknowledged Kozinn. "There is also political and social pressure to allow more individuals to have access to the same wealth-growing opportunities as those who are already wealthy. Access shouldn't be restricted to the rich because they satisfy this higher bar of being an accredited investor." He concluded that "in that context, expansion of the accredited-investor context makes sense."

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