Noteworthy recent SEC rule changes

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At an open meeting held on August 26, the Securities and Exchange Commission (the " SEC" or the "Commission") took several actions that can be expected to have a significant impact on private securities offerings and the preparation of SEC filings. Specifically, the Commission voted to approve expanding the definition of "accredited investor," which is used to determine eligibility to participate in private offerings and amending selected provisions of Regulation S-K, which sets forth the requirements for non-financial disclosures to be made by reporting companies.

The amendment to the definition of "Accredited Investor" is effective 60 days after publication in the Federal Register, and the modernization of Regulation S-K Items 101, 103 and 105 is effective 30 days after publication in the Federal Register.

Accredited Investor Definition

Private offerings are typically limited, either entirely or mostly depending on the type of offering, to accredited investors. For more than three decades, the SEC strictly defined the term accredited investor on the basis of financial metrics, principally annual income or net worth. Only persons whose net worth exceeded $1 million (not including the value of his or her principal residence) or whose annual income in each of the previous two years exceeded $200,000 (or, when aggregated with a spouse, $300,000), or entities owned exclusively by accredited investors or with total assets in excess of $5 million (and not formed for the investment at hand), would qualify.

That part of the definition has not changed. But the Commission's recent action has broadened its scope to take into account, among other things, qualification and entity-based factors, as follows:

Persons

- *Licensing and Certifications* – Certain professional credentials will now qualify a person as an accredited investor. The Commission has initially designated those persons who hold, in good standing, any of FINRA licenses Series 7 (general securities representative), Series 65 (investment adviser representative) and Series 83 (private securities offering representative) in the amended rule but contemplates future expansion to include other relevant licenses or certifications.
- *Knowledgeable Employees* – Private funds may now consider certain of their employees as accredited investors for purposes of investing in the fund, regardless of whether they meet the net worth or annual income tests. These employees include executive officers, directors, trustees, general partners, advisory board members, and affiliates who oversee the fund's investments and other employees and affiliates who have participated in the fund's investment activities for at least 12 months.

Entities

- *Investment advisers* – Those investment advisory firms that are registered either under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), or state law, or that are considered exempt under Sections 203(l) or (m) of the Advisers Act are now accredited investors.
- *Rural Business Investment Companies (RBICs)* – Those companies that meet the definition of RBIC in Section 384A of the Consolidated Farm and Rural Development Act are now accredited investors.
- *Limited Liability Companies (LLCs)* – Any LLC that meets the financial standards for an accredited investor for entities specified above will now be considered one (this particular amendment is a codification of a position long-held by the SEC staff).

- *Family Offices* – An entity that meets the definition of "family office" set forth in Rule 202(a)(11)(G)-1 of the Advisers Act is now an accredited investor so long as it meets the entity-based financial standards and is directed by a person with knowledge and experience such that she or he is capable of judging the merits of the prospective investment.

Other Amendments

- *Spousal Equivalent* – As noted above, the financial threshold for an accredited investor could be met when the annual incomes of a person and their spouse were aggregated; this rule has now been expanded to include "spousal equivalents," i.e., co-habitants.
- *"Catch-All"* – Entities not formed for the purpose of acquiring specific securities- such as Native American tribes, governmental agencies, funds, and non-U.S. entities-can qualify as accredited investors so long as they have $5 million in "investments," as defined in Rule 2a51-1(b) of the Investment Company Act of 1940, as amended.
- *Qualified Institutional Buyers* – Similar amendments to the ones described above have been made to the definition of "qualified institutional buyers" under Rule 144A of the Securities Act of 1933, as amended, which creates a safe harbor from registration for the resale of restricted securities to institutional investors with at least $100 million in assets. The amendments have formally added LLCs and RBICs to the list of entities that may be considered qualified institutional buyers. The other entities contemplated by the catch-all amendment discussed immediately above can now also so qualify.

Regulation S-K

Similar to the accredited investor definition, Regulation S-K has been largely unchanged for approximately three decades. But for several years, the SEC's Division of Corporation Finance has pursued a Disclosure Effectiveness Initiative, which is designed to eliminate duplication and redundancies in SEC filings, and the amendments to the regulation that the Commission has just approved are part of that effort.

The provisions affected by the amendments are Item 101 (Business), Item 103 (Legal Proceedings), and Item 105 (Risk Factors). As a general matter, the Disclosure Effectiveness Initiative has sought to make public company disclosure more principles-based, and each of these amendments was crafted with that objective in mind, as follows:

Item 101

- Registrants previously were required to discuss their businesses with a prescribed five-year lookback period (or three years for smaller reporting companies). Now they may prepare their disclosure based solely on information that is material to an understanding of the business as it has developed over whatever timeframe is relevant.
- After initial broad-based disclosure of the nature of the business has been made, registrants may in subsequent filings provide only updates, including any material changes to business strategy, incorporating by reference to the filing where the fuller discussion of the business appears.
- As alluded to above, to the extent they are material, registrants are now required to describe their "human capital resources," however they define that term with their own industries in mind, in their business discussion. One example of human capital would be how a company attracts, develops, and retains personnel.
- In the description of their regulatory compliance, registrants must discuss all material governmental regulations, and not only environmental ones.

Item 103

- The required disclosure may now be made through hyperlinks or cross-reference to a discussion of the material legal proceedings located elsewhere in the filing (most often in the Notes to the Financial Statements) in order to avoid duplication; this is a codification of a practice many registrants had already utilized.
- The financial threshold for disclosing certain regulatory sanctions involving environmental protection has been increased from $100,000 to $300,000; registrants may, however, elect a different threshold so long as it does not exceed the lesser of $1 million or 1% of the registrant's current assets.

Item 105

- Registrants must now provide a summary of their risk factor disclosure, to run no more than two pages, if the main risk factor disclosure is longer than 15 pages (which, historically for most registrants, has nearly always been the case); many reporting companies have summarized their risk factors in their forward-looking statements disclaimer (or, in registration statements, in the prospectus summary) but should now consider moving this summary to the beginning of the risk factors section.
- In following the principles-based approach, public companies should strive to include only those risk factors that it considers material to their business.
- In addition to the existing requirement to introduce a risk factor with a relevant sub-caption, registrants must now group each set of risk factors under an appropriate heading (this is another practice that many registrants had heretofore commonly followed).

For more information on this topic and to answer any questions you may have, please contact your regular Withers attorney or the author of this piece

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