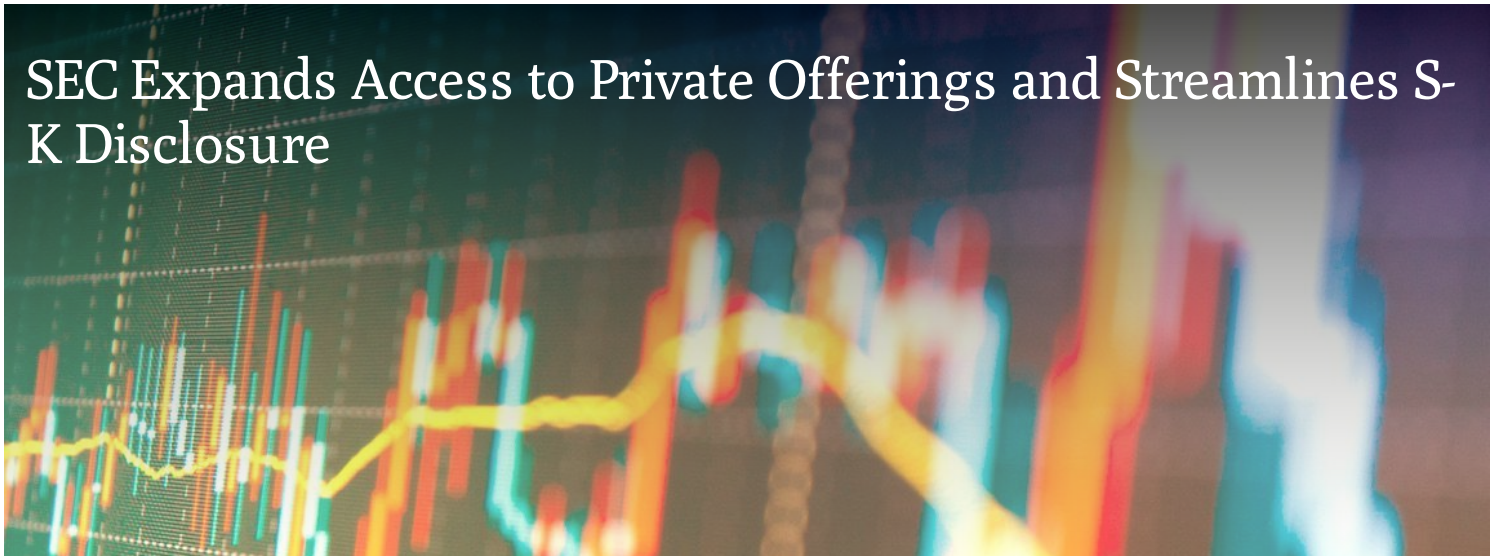
WINSTON & STRAWN LLP

BLOG



SEC Expands Access to Private Offerings and Streamlines S-K Disclosure

AUGUST 27, 2020

Yesterday, the Securities and Exchange Commission (the SEC) adopted new rules of significance for both private securities offerings and mandatory public company disclosures, in line with key SEC policy initiatives. First, to increase investor access to the expanding private securities markets, the SEC expanded the definition of "accredited investors" to increase the pool of investors eligible to invest in private placements offered by private equity, hedge fund, and other private companies. Second, in line with its emphasis on "principles-based" disclosure, the SEC streamlined aspects of its Regulation S-K disclosure rules to focus disclosure increasingly on materiality assessments specific to each issuer (rather than fixed dollar thresholds). Finally, to aid investor understanding of key business issues, the SEC is also requiring summaries (not exceeding two pages in length) of risk factor sections that exceed 15 pages in length, in response to the concern that risk factor sections, simply by virtue of their length, can obscure important risk disclosures.

The Definition of "Accredited Investor"

Specifically, the SEC expanded the definition of "accredited investor" under Section 501 of the Securities Act of 1933 (the Securities Act) to include persons holding specified professional "certifications, designations, or credentials," which the SEC may designate from time to time. Accredited investors are permitted to invest in private placements under Regulation D of the Securities Act, and, thus, they have access to the private offerings conducted by private equity, hedge funds, and large private companies. These offerings are practically foreclosed to investors not meeting the qualifications for accredited investor status set forth in Rule 501. The SEC began this regulatory initiative by expanding the definition of "accredited investor" to include holders of stockbrokers' licenses, including Series 7, Series 65, and Series 82 licenses. The SEC rule change indicates that it may consider adding the holders of other professional certifications to the definition of accredited investors.

The new rule also provided that accredited investors shall include "family offices," which more than $5 million in assets under management and their "family clients," as defined in the Investment Advisers Act.[1] This category has been limited to "companies" with more than $5 million under management.

Finally, the rule also provides that "knowledgeable employees" of investment funds (who are offering the securities) also qualify as accredited investors.[2] The SEC's actions were driven by the expansion of private securities markets

over recent years, and its desire to allow more investors to participate in them. The SEC noted that last year $2.7 trillion was raised in private securities offerings, more than double the $1.2 trillion raised in public offerings now open to retail investors. Below, this post discusses the rule changes made to the definition of "accredited investor" under Rule 501:

NEW ACCREDITED INVESTORS	DESCRIPTION
Natural Persons	Amend Rule 501(a) to add a new category permitting natural persons to qualify as accredited investors based on certain professional certifications, designations, or credentials issued by an accredited education institution (which the SEC may designate from time to time by order). Amend 501(a) to designate holders in good standing of the Series 7, Series 65, and Series 82 licenses as qualifying natural persons.
Knowledgeable Employees	Amend Rule 501(a) to include as accredited investors, with respect to investments in a private fund, natural persons who are "knowledgeable employees" of the fund.
Limited Liability Companies ("LLCs") and Investment Advisors	Amend Rule 501(a) to clarify that LLCs with $5 million in assets may be accredited investors and add SEC- and state-registered investment advisors, exempt reporting advisers, and rural business investment companies to the list of entities that may qualify.
Entities that Own "Investments" Under Rule 2a51-1(b) of the Investment Company Act (the "ICA")	Amend Rule 501(a) to create a new category for any entity, including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries, that owns "investments" as defined in Rule 2a51-1(b) of the ICA, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered.
Family Offices	Amend Rule 501(a) to add "family offices" with at least $5 million in assets under management and their "family clients" (as those terms are defined under the Investment Advisers Act).
Spousal Equivalents	Amend 501(a) to add the term "spousal equivalent" to the accredited investor definition, so that natural persons may include joint income from spousal equivalents when calculating income under Rule 501(a)(6) and to include spousal equivalents when determining net worth under Rule 501(a)(5).

The SEC also adopted amendments to the definition of "qualified institutional buyers" under Rule 144A to expand the lists of entities that are eligible to qualify as qualified institutional buyers, specifically "any institutional accredited investor, as defined in rule 501(a)." The rules avoid inconsistencies between the entity types eligible for each status

while continuing to ensure that these entities have sufficient financial sophistication to participate in investment opportunities that do not have the additional protections provided by registration under the Securities Act.

Increased Emphasis on Materiality Assessments in Regulation S-K

Regulation S-K sets forth the body of business and legal disclosures required in SEC periodic reports and prospectuses. The new SEC rules require companies to disclose information material to the development of the business irrespective of a particular time period (e.g., five years). Similarly, the SEC allows a company to devise its own thresholds for disclosures of environmental proceedings rather than over a particular time period, so long as its threshold is low enough to capture material issues and does not exceed the lesser of $1 million or 1% of current assets. This allows companies to essentially fashion for themselves an exemption to current disclosure rules that require disclosure of environmental proceedings with potential sanctions of $100,000 to $300,000.

The new rules also require disclosures of “human capital resources” to the extent material to an understandings of the company’s business.

Summaries of Risk Factor Sections

SEC rules required that public reports and prospectuses include disclosure of “risk factors” applicable to an investment in the company’s securities. These sections have become longer and longer over time, with the result that many exceed 20 pages in length. Obviously, not every risk factor necessarily deserves equal importance in the mind of investors. Accordingly, the SEC has amended its rules to require a company to include a summary of risk factors, not more than two pages in length, whenever its risk factor section exceeds 15 pages in length. To avoid claims that the summary itself is misleading, this new rule will put both companies and their attorneys to the task of identifying the most serious risk factors and highlighting them in the two-page summary. Companies may respond to this new rule by simply shortening their risk factor section to 15 pages.

The following chart describes in further detail each SEC rule change to Regulation S-K:

ITEM #	TOPIC	DESCRIPTION

ITEM #	TOPIC	DESCRIPTION
101	Description of Business	Amend Item 101(a) (Description of Business) by: • requiring disclosure of information material to an understanding of the general development of the business; • replacing the previous five-year timeframe with a "materiality framework" (i.e., focus on information material to an understanding of the development of the business, irrespective of a specific timeframe); and • permitting companies, in filings made after an initial filing, to provide only an update of the general development of the business (focused on material developments that have occurred since its most recent full discussion). Amend Item 101(c) (Narrative Description) by: • providing a non-exclusive list of disclosure topic examples drawn, in part, from topics currently listed in Item 101(c); • including, as a disclosure topic, a description of the company's human capital resources, to the extent such disclosures would be material to an understanding of the company's business; and • refocusing the regulatory compliance disclosure requirement by including, as a topic, all material regulations, not just environmental laws.
103	Legal Proceedings	Amend Item 103 (Legal Proceedings) by: • expressly stating that the required information may be provided by hyperlink or cross-reference to legal proceedings disclosures located elsewhere in the filing, thus avoiding duplicative disclosures; and • implementing a modified disclosure threshold for certain governmental environmental proceedings resulting in monetary sanctions that increases the existing qualitative threshold for disclosure of those proceedings from $100,000 to $300,000, but also affording a company some flexibility by allowing it to select a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings, provided that the threshold does not exceed the lesser of $1 million or 1% of the current assets of the company.

ITEM #	TOPIC	DESCRIPTION
105	Risk Factors	Amend Item 105 (Risk Factors) by: • requiring summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages in length; • refining the principles-based approach of Item 105 by requiring disclosure of "material" risk factors; and • requiring risk factors to be organized under relevant headings in addition to the sub-captions currently required, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section (under a separate caption).

In the SEC's Open Meeting discussing the changes to Items 101, 103, and 105, many of the commissioners emphasized the new human capital disclosures. Two of the commissioners said they would have required additional disclosures related to human capital, particularly in reference to diversity efforts within companies, as well as climate-related disclosures. In response, Chairman Jay Clayton noted the SEC's recently issued board diversity disclosure requirements, as well as a prospective ESG-related advisory committee that could provide guidance to the SEC on additional disclosures in the future.

Conclusion

Capital Markets & Securities Law Watch will provide a link to the adoptive amendments relating to the changes to Regulation S-K when they are published by the SEC and will continue to update our blog with additional information as it becomes available.

---

[1] *See* Rule 275.202(a)(11)(G) of the Investment Advisers Act ("A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that: (1) has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event; (2) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) does not hold itself out to the public as an investment adviser.")

[2] *See* SEC, Release No. 33-10824 on Amending the "Accredited Investor" Definition at 11 (the SEC proposed to add "natural persons who are "knowledgeable employees," as defined in Rule 3c– 5(a)(4) under the Investment Company Act of 1940…of the private-fund issuer of the securities being offered or sold.")

8 Min Read

Authors

Michael J. Blankenship

J. Eric Johnson

John P. Niedzwiecki

Ben D. Smolij

Related Locations

Chicago | Houston

Related Topics

Securities and Exchange Commission (SEC) | Accredited Investor | Risk Factors

Related Capabilities

Capital Markets | Transactions

Related Regions

North America

Related Professionals

Michael J. Blankenship

J. Eric Johnson

John P. Niedzwiecki

Ben D. Smolij

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.