Proposed Amendments to SEC Rules that Capital Markets Lawyers Will Want to Track: Expanding the Definitions of "Qualified Institutional Buyer" and "Accredited Investor" and Updating Auditor Independence Requirements

I. Background

On December 18, 2019, the Securities and Exchange Commission ("SEC") proposed amendments to the definitions of "qualified institutional buyer" under Rule 144(a)(1) of the Securities Act of 1933 (the "Securities Act") and "accredited investor" under Rule 501(a) of Regulation D under the Securities Act.[1] The proposed amendments would make certain changes to the definition of "qualified institutional buyer" to add additional entity types that meet the $100 million threshold of the rule and to create consistency between entities that are eligible for qualified institutional buyer ("QIB") status and those eligible for accredited investor ("AI") status.[2] In addition, the proposed amendments to the accredited investor definition would:

- Add new categories that would allow natural persons to qualify based on certain professional certifications, designations or credentials or, with respect to investments in a private fund, based on the natural person's status as a "knowledgeable employee";[3]
- Add certain entity types to the current list of entities that may qualify and add a new category for any entity owning "investments" (as defined in 17 CFR 270.2a51-1(b) under the Investment Company Act of 1940) over $5 million not formed for the specific purpose of investing in the offered securities;[4]
- Add "family offices" with a minimum of $5 million in assets under management and their "family clients" (as each term is defined under the Investment Advisers Act of 1940);[5]
- Add the term "spousal equivalent," so they may pool their finances for the purpose of qualifying;[6] and
- Codify certain related staff interpretive positions.[7]

The SEC explained that the purpose of the proposed changes is to better identify investors with certain knowledge and expertise who would not need the protection of registration under the Securities Act.[8]

On December 30, 2019, the SEC proposed amendments to update auditor independence requirements.[9] The proposed amendments would:

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[1] *See Amending the "Accredited Investor" Definition*, Release Nos. 33-10734, 34-87784 (Dec. 18, 2019), available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf [hereinafter "*QIB/AI Amendments*"].

[2] *See id.* at 11.

[3] *See id.* at 10–11.

[4] *See id.* at 11.

[5] *See id.*

[6] *See id.*

[7] *See id*.

[8] *See id.* at 1.

[9] *See Amendments to Rule 2-01, Qualifications of Accountants*, Release Nos. 33-10738, 34-87864 (Dec. 30, 2019), available at https://www.sec.gov/rules/proposed/2019/33-10738.pdf [hereinafter "*Auditor Independence Amendments*"].

- Amend the definitions of "affiliate of the audit client" and "investment company complex" to focus on certain affiliate relationships;[10]
- Reduce the look-back period for domestic first time filers;[11]
- Add certain student loans and de minimis consumer loans to the exclusions from lending relationships impairing independence;[12]
- Replace "substantial stockholders" under the business relationship rule with "beneficial owners with significant influence";[13]
- Present a transition framework for mergers and acquisitions;[14] and
- Make other updates.[15]

In proposing these changes, the SEC explained that it is attempting to sharpen the focus on relationships and services that are most likely to threaten the objectivity and impartiality of the auditor.[16]

II. Amendments Overview

A. "Qualified Institutional Buyer"

The QIB/AI Amendments would expand the types of entities that constitute QIBs.[17] Under the existing framework, Rule 144A(a)(1)(i) defines "qualified institutional buyer" as "[a]ny of the following entities, acting for its own account or the accounts of other [QIBs], that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity."[18] Rule 144(a)(1)(i) then lists certain entity types that qualify as QIBs.[19]

The proposed amendments to the QIB definition would add certain new categories of entity types that meet the existing $100 million threshold, including:

- rural business investment companies;
- limited liability companies; and
- any other entity type not already included in the definition.[20]

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[10] *See id.* at 70.

[11] *See id.*

[12] *See id.*

[13] *See id.*

[14] *See id.* at 70–71.

[15] *See id.* at 71.

[16] *See id.* at 6.

[17] *See QIB/AI Amendments*, *supra* note 1, at 88–93.

[18] 17 C.F.R. 230.144A(a)(1)(i) (2020).

[19] *See* 17 C.F.R. 230.144A(a)(1)(i)(A)–(I) (2020).

[20] *See QIB/AI Amendments*, *supra* note 1, at 88–93.

In proposing these amendments, the SEC reasoned that requiring these new entity types to meet the existing $100 million threshold will demonstrate the requisite financial sophistication to constitute a QIB[21] and noted that its proposal was intended to conform with the changes it was proposing to the definition of "accredited investor," summarized below.[22]

B. "Accredited Investor"

The QIB/AI Amendments would change the definition of "accredited investor" in Rule 501(a) of Regulation D and make conforming changes to Rule 215 under the Securities Act[23] by adding new categories within the definition and modifying certain existing categories.[24] Like the definition of QIB, the definition of "accredited investor" sets forth several categories that constitute accredited investors.[25] The proposed amendments would add new categories of entities, including:

- registered investment advisors;
- rural business investment companies;
- limited liability companies that satisfy the other requirements of the definition;
- any entity owning investments over $5 million and "not formed for the specific purpose of acquiring the securities being offered"[26] (e.g., Indian tribes, governmental bodies, and entity types that may be created in the future); and
- "family offices" with at least $5 million in assets under management and its "family clients," so long as (i) the family office is "not formed for the specific purpose of acquiring the securities offered"[27] and (ii) the family client is a family client of a family office meeting the requirements.[28]

The proposed amendments also include the following new categories of natural persons:

- natural persons with certain professional certifications, designations, or other credentials (e.g., Series 7, Series 65, Series 82); and
- "knowledgeable employees" of private funds, for purposes of investments in the funds (e.g., trustees, advisory board members, people serving in similar capacity, and people who "in connection with the employees' regular functions or duties, have participated in the investment activities of such private fund for at least 12 months."[29]).[30]

[21] *See id.* at 92.

[22] *See id.* at 91.

[23] *See id.* at 10, n.30.

[24] *See id.* at 10–11.

[25] *See* 17 C.F.R. 230.501(a) (2020).

[26] *QIB/AI Amendments*, *supra* note 1, at 56.

[27] *Id.* at 63.

[28] *See id.* at 47–57, 60–63.

[29] *Id.* at 43.

[30] *See id.* at 27–30, 43.

Finally, the proposed amendments would permit spousal equivalents to pool their finances for purposes of qualifying as "accredited investors" under Rule 501(a)(6),[31] and include other miscellaneous changes.[32] By adding new categories entities and individuals, the SEC stated that it hoping to identify entities and people that have the aptitude to assess investments, irrespective of wealth.[33]

C. Auditor Independence

In proposing the Auditor Independence Amendments, the SEC explained that it was focused "on those relationships and services that are most likely to threaten auditor objectivity and impartiality"[34] and believed that the proposed changes will lower compliance costs for auditors and their clients "by updating certain aspects of the auditor independence requirements that may be unduly burdensome."[35] The principal changes are summarized below.

i. "Affiliate of the Audit Client" and "Investment Company Complex"

To further the purposes set forth above, the proposed amendments address the definitions of "affiliate of the audit client" and "investment company complex."[36] Under the current version of Rule 2-01(f)(4), the definition of "affiliate of the audit client" includes "[a]n entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries."[37] Rule 2-01(f)(14) similarly uses the phrase "common control" in setting forth the scope of the definition of "investment company complex."[38]

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[31] *See id.* at 66. ("The proposed amendments would define spousal equivalent as a cohabitant occupying a relationship generally equivalent to that of a spouse."). Under the current "accredited investor" definition, individuals and their spouses can qualify as an accredited investor if they have over $300,000 in joint income or $1,000,000 in joint net worth. *See* 17 C.F.R. 230.501(a)(5)–(6) (2020).

[32] Such changes include, but are not limited to, amendments to: (1) Rule 501(a)(8) of the Securities Act (clarifying that if (i) all natural persons who own an entity are accredited investors and (ii) all other owners of equity of the entity are also accredited investors, then the entity constitutes an accredited investor under Rule 501(a)(8)); (2) Rule 215 of the Securities Act (conforming the definition of "accredited investor" in Rule 215 to the amendments to the same definition in Rule 501(a)); (3) Rule 163B of the Securities Act (including a reference to proposed Rule 501(a)(9) and Rule 501(a)(12) in the "testing-the-waters" rule); and (4) Rule 15g-1 of the Securities Exchange Act of 1934 (the "Exchange Act") (including a reference to proposed Rules 501(a)(9) and 501(a)(12) of the Securities Act when referring to "accredited investor" under Rule 15g-1(b)). *See QIB/AI Amendments*, *supra* note 1, at 59–60, 68, 69–70, 71.

[33] *See id.* at 21.

[34] *See Auditor Independence Amendments*, *supra* note 9, at 10.

[35] *Id.* at 49.

[36] *See id.* at 7–24.

[37] 17 C.F.R. 210.2-01(f)(4) (2020).

[38] *See* 17 C.F.R. 210.2-01(f)(14) (2020). The definition of "investment company complex" under Rule 2-01(f)(14) includes, in relevant part, "[a]ny entity controlled by or controlling an investment adviser or sponsor . . . or any entity under common control with an investment adviser or sponsor" so long as "the entity: (1) [i]s an investment adviser or sponsor; or (2) [i]s engaged in the business of providing administrative, custodian, underwriting or transfer agent services to any investment company, investment adviser, or sponsor." 17 C.F.R. 210.2-01(f)(14)(i)(B)(1)–(2) (2020).

The SEC noted that, under the current rules, the responsibility for monitoring auditor independence applies to affiliates of the audit client, even if those entities are not material to the controlling entity.[39] The proposed amendments therefore include changes to the definitions of "affiliate of the audit client"[40] and "investment company complex"[41] to add a materiality requirement for operating companies under common control.[42] In doing so, the SEC stated that it hopes fewer entities will be considered affiliates, which should lighten the burden in determining auditor independence under these rules and avoid inadvertent overinclusiveness.[43]

ii. Look-Back Period

The proposed amendments also include changes to the professional engagement period of auditors.[44] Under the current rules, an "auditor of a domestic issuer engaging in an IPO has to be independent in accordance with Rule 2-01 during all periods included in the issuer's registration statement filed with the [SEC]."[45] By contrast, the auditor of a foreign private issuer engaging in the same IPO would have to assess its independence under Rule 2-01 for only the past fiscal year.[46] To fix this discrepancy, the proposed amendments would amend Rule 2-01(f)(5)(ii) to apply the one-year look-back period to all first-time filers.[47] As for services provided prior to the look-back period as set forth in the proposed amendments, the SEC noted that the "general standard" of auditor independence under Rule 2-01(b) still applied.[48]

iii. Student Loans and De Minimis Consumer Loans

The proposed amendments also address certain student loans and consumer loans in the context of auditor independence.[49] The SEC explained that under the "Loan Provision" (Rule 2-01(c)(1)(ii)(A)), if an accountant, accounting firm, covered person in the firm, or any immediate family member of such accountant have loans to or from certain persons or entities related to the audit client, then he or she is not independent.[50] Acknowledging that

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[39] *See Auditor Independence Amendments*, *supra* note 9, at 8.

[40] 17 C.F.R. 210.2-01(f)(4) (2020) (defining "affiliate of the audit client").

[41] 17 C.F.R. 210.2-01(f)(14) (2020) (defining "investment company complex"). The SEC stated that its proposed amendments to this definition aim "to focus the definition from the perspective of the entity under audit and align certain portions of the ICC definition with the amendments" concerning "common control" and the "affiliate of the audit client." *Auditor Independence Amendments*, *supra* note 9, at 15. It also proposed adding a "significant influence" prong to the definition of "investment company complex." *See id.* at 23.

[42] *See Auditor Independence Amendments*, *supra* note 9, at 10. The specific proposal is to add the following qualifier to the definition of "affiliate of the audit client": "unless the entity is not material to the controlling entity." *Id.* at 11. The *Auditor Independence Amendments* include certain other amendments to the definitions of "affiliate of the audit client" and "investment company complex and provides further clarity in how to analyze issues under each definition. *See id.* at 7–24.

[43] *See id.* at 13–14.

[44] *See id.* at 24–28.

[45] *Id.* at 25.

[46] *See id.*

[47] *See id.* at 27.

[48] *See id*. Rule 2-01(b) applies an "all relevant facts and circumstances" legal standard in determining independence of accountants. 17 C.F.R. 210.2-01(b) (2020).

[49] *See Auditor Independence Amendments*, *supra* note 9, at 28–33.

[50] *See id.* at 28.

not all of these relationships should cause issues with auditor objectivity,[51] the proposed amendments would add a student loan exclusion, so long as the "student loans [were] obtained from a financial institution under its normal lending procedures, terms, and requirements for a covered person's educational expenses [and] provided the loan was obtained by the individual prior to becoming a covered person in the firm as defined under Rule 2-01(f)(11)."[52]

Regarding consumer loans, Rule 2-01(c)(1)(ii)(E) currently states that "[a]n accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediately family members has . . . [a]ny aggregate outstanding credit card balance owed to a lender that is an audit client" as long as it "is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period."[53] The proposed amendments would replace the reference to "credit cards" with "consumer loans" and amending this language "to reference any consumer loan balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and available grace period."[54]

iv. "Substantial Stockholders"

The proposed amendments also address the "Business Relationships Rule" (Rule 2-01(c)(3)).[55] Under the existing rule, an accounting firm or covered person in the firm "is not independent if, at any point during the audit and professional engagement period, [it] has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity," which includes "an audit client's officers, directors, or *substantial stockholders*."[56] To address the fact that "substantial stockholders" is not defined in Rule 2-01, the proposed amendments would replace "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client."[57] The SEC noted that its guidance in this area, including its emphasis on "significant influence," should similarly apply to the "Loan Provision" referenced above.[58]

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[51] *See id.*

[52] *Id.* at 30. The SEC also provided clarification with respect to a reference to a "mortgage loan" in the rules. *See id.* at 31. Under Rule 2-01(c)(1)(ii)(A)(1)(iv):

> [a]n accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediately family members has . . . [a] mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

17 C.F.R. 210.2-01(c)(1)(ii)(A)(1)(iv) (2020). In the *Auditor Independence Amendments*, the SEC "clarif[ied] that the reference to 'a mortgage loan' in Rule 2-01(c)(1)(ii)(A)(*1*)(iv) was not intended to exclude just one outstanding mortgage loan on a borrower's primary residence." *Auditor Independence Amendments*, *supra* note 9, at 31.

[53] 17 C.F.R. 210.2-01(c)(1)(ii)(E) (2020).

[54] *Auditor Independence Amendments*, *supra* note 9, at 32–33.

[55] *See id.* at 34–35.

[56] 17 C.F.R. 210.2-01(c)(3) (2020) (emphasis added).

[57] *Audit Independence Amendments*, *supra* note 9, at 34–35.

[58] *See id.* at 37.

v. Transition Framework for Mergers and Acquisitions

The proposed amendments also address inadvertent violations of auditor independence rules as a result of mergers and acquisitions.[59] Because it can be hard to predict whether a merger or acquisition will result in a violation of the auditor's independence rules, the proposed amendments include a transition framework in which the accounting firm's independence would not be impaired following an audit client's merger or acquisition if the accounting firm:

- is in compliance with the independence standards related to the applicable services or relationships when such services or relationships started and throughout the period when the independence standards apply;[60]
- corrects any independence violations arising from a merger or acquisition as promptly as possible under the circumstances;[61] and
- has a quality control system in place (as described in Rule 2-01(d)(3)) that includes the following features:
- procedures and controls to monitor the audit client's merger and acquisition activity, providing timely notice of any merger or acquisition; and
- procedures and controls that facilitate prompt identification of potential violations after notification of a potential merger or acquisition that might trigger independence violations, but prior to the occurrence of the transaction.[62]

The SEC recognized that what constitutes "as promptly as possible" will depend on the facts and circumstances, but noted it is expected that corrective action will be taken no later than six months after the effective date of the merger or acquisition that caused the violation.[63]

III. Conclusion

The proposed amendments are intended to facilitate capital markets transactions by broadening the scope of investors who are eligible to participate in private capital raising[64] and by sharpening the focus of what constitutes auditor independence for public companies.[65] The SEC has stated that it believes that the QIB/AI Amendments will provide a better proxy for identifying individual and institutional investors with the requisite knowledge to participate in the private capital markets without further protection under the Securities Act,[66] and that the Auditor Independence Amendments will better focus the independence analysis on certain services or relationships that are

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[59] *See id.* at 38–42.

[60] *See id.* at 40, 83.

[61] *See id.* at 41, 84.

[62] *See id.*

[63] *See id.* at 41–42. The proposed amendments would also make certain miscellaneous changes to Rule 2-01, including: (1) replacing references to "concurring partner" to "Engagement Quality Reviewer" in Rule 2-01 to catch up with recent amendments; (2) a technical amendment to turn the current Preliminary Note to Rule 2-01 into the introductory text of Rule 2-01; and (3) deleting Rule 2-01(e), which was an outdated transition and grandfathering provision, and reserving it for certain proposed amendments. *See id.* at 43–44.

[64] *See QIB/AI Amendments*, *supra* note 1, at 1.

[65] *See Auditor Independence Amendments*, *supra* note 9, at 1.

[66] *See QIB/AI Amendments*, *supra* note 1, at 1.

more likely to threaten the objectivity and impartiality of the auditor.[67] Comments to the QIB/AI Amendments and the Auditor Independence Amendments are due on or before March 16, 2020.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Brockton Bosson at 212.701.3136 or bbosson@cahill.com; Chérie R. Kiser at 212.701.8950 or ckiser@cahill.com; Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; John Papachristos at 212.701.3691 or jpapachristos@cahill.com; Ross Sturman at 212.701.3831 or rsturman@cahill.com; or Alex J. Kramer at 212.701.3899 or akramer@cahill.com.

[67] *See Auditor Independence Amendments*, *supra* note 9, at 1.