

Recent Modifications to the Accredited Investor and Qualified Institutional Buyer Definitions

A Discussion with Marty Margolis, CIO

Q&A | September 2020



The Securities and Exchange Commission (SEC) recently adopted a long-sought change to the rules that limit sales of certain private market securities. The change will expand access for state and local governments to commercial paper, negotiable bank deposits and corporate bonds. Amendments to the rules defining an “accredited investor” and a “qualified institutional buyer” (QIB) put governments on the same plane as corporations and not-for-profit entities. PFM Asset Management LLC played an active role in promoting this change, and we believe comments and recommendations we submitted to the Commission were recognized in the new rule.

In an effort to learn more about the changes and their impact on public sector investors, we conducted the following Q&A session with Marty Margolis. Marty founded the investment management business at PFM and currently serves as its chief investment officer.

What are the highlights of the new rule? Who now qualifies?

Margolis: The amended rule is a result of a decade of work by the SEC to expand access to private market securities. These securities, which include certain forms of commercial paper, negotiable bank deposits and corporate bonds, are exempt from registration under federal securities laws. In order to protect investors that might purchase these unregistered securities, the SEC limits the purchases and sales of these securities to specific types of institutions. Until the change, state and local governments, no matter their size, were not included in the definition of “accredited investor” or “qualified institutional buyer” and thus were left out of this segment of the market. Other groups of potential investors, such as persons with certain professional qualifications, certain kinds of business organizations, Indian tribes and family offices were similarly excluded.

However, the new rule now includes these types of entities. It also seeks to apply principles-based rules so rather than classifying investors by type of entity, it applies principles, including the level of sophistication and/or asset size uniformly across entities.

Investors — other than natural persons who are qualified by professional qualification — must meet an asset test. They must control at least \$5 million in assets to qualify as an accredited investor and must own \$100 million of securities to be a qualified institutional buyer.

Technically, the rule accomplished this by adding a new category of accredited investor “for any entity, including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries, that own ‘investments,’ as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of \$5 million and that was not formed for the specific purpose of investing in the securities offered.”¹ The rule also made the definition of qualified institutional buyer consistent with the change in accredited investor qualifications while maintaining the traditional \$100 million threshold. This now includes state and local governments, as well as tribal governments.

The net effect of all this is that it materially increases the investment options to a broad set of investors that had previously been sidelined by the prior definitions.

¹ <https://www.sec.gov/news/press-release/2020-191>.



Why are these changes important for public sector investors?

Margolis: Being recognized as an accredited investor or a QIB can make a world of difference by providing the investor with access to private market offerings. These include commercial paper offerings covered by 4(a)(2) of the 1933 Securities Act, bank obligations issued under Section 3(a)(2) of the same act, and private placements, often referred to as 144a obligations. While these types of investments once made up a minor portion of the investment-grade money and credit markets, issuers have increasingly resorted to these registration exemptions. To offer some perspective, based on our research, more than 75% of the commercial paper market is now comprised of exempt securities and roughly 22% of the ICE BofAML Corporate Bond Index includes restricted securities, among them, those that are 144a eligible.²

As the universe of non-exempt issuance shrank in recent years, government entities were forced either to concentrate their investments in a few issuer names or limit purchases of corporate credit instruments. This led them to invest largely in lower-yielding government obligations, which (especially) in a low-interest rate environment, compounded an already challenging investment picture.

Not-for-profit entities recognized under Section 501(c)(3) of the Internal Revenue Code that otherwise met the asset test qualified previously to this rule change and some government entities could also be deemed to qualify if they provided similar services; but the new rule adds clarity and transparency to this definition.

Why did the SEC enact these changes now?

Margolis: The impetus for this change comes from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2013 which mandated that the SEC conduct periodic reviews of the accredited investor limits with the goal of harmonizing private and public market approaches and simplifying capital raising.

The Commission was also mandated to consider investor protections that the restrictions provide.

The SEC's analysis sought input from issuers, investors and the general public. In response, several state and local governments and organizations such as the National Association of State Treasurers advocated for the inclusion of governmental entities in the definition. As part of this process, PFM offered guidance and suggestions to the Commission, and these were considered in the new rule.

What is PFM's interest, if any, in the rule change?

Margolis: PFM is one of the largest investment advisers in the United States that specializes in advising state, local governments and non-profit institutions. The newly modified definitions provide many of these investors, including our clients, with an expanded range of investment options and the potential for greater diversification. Of course, thinking about the bigger picture, increasing the number of potential investors in certain areas of the capital markets, by definition, also enhances liquidity and is therefore beneficial for all investors. In the current interest rate environment, with public sector clients increasingly looking for ways to increase their return as safely as possible, this will broaden the opportunity set for many governmental investors to consider as part of their overall fixed income investment strategy.

Are all governmental entities now able to buy private market (restricted) investments?

Margolis: While these rules apply to all entities, including governmental entities, it's important to understand that there are still limitations on which investors may participate. Smaller investors, those that don't meet the size requirements, are still not qualified to buy and sell these types of investments. However, all governmental entities, regardless of size, can access those investments through other vehicles such as properly organized local government investment pools (LGIPs).

² www.crowell.com/NewsEvents/AlertsNewsletters/all/SEC-Finalizes-Amendments-to-the-Definitions-of-Accredited-Investor-and-Qualified-Institutional-Buyer.



What is the downside or risk, if any, to these rule changes?

Margolis: In the past, private market securities were considered to be much less liquid than those available to the general public, but the liquidity characteristics have changed as issuers shifted to using these exemptions. With the broadened definition of potential buyers in the new rule, liquidity should be further improved. That said, liquidity is likely to remain lower for these types of instruments.

Private markets are also the venue for issuance of highly leveraged and very complex securities. Not all private market securities are of equal risk and this is why the SEC has maintained requirements for being a sophisticated investor and therefore capable of making the proper investment decisions within private markets. Investors should also be even more diligent in working with their own investment staff, or their investment advisor, to evaluate the offerings available to accredited investors and QIBs, and do their due diligence on the securities offered.

For more information, please contact your PFM relationship manager.

To learn more or discuss in greater detail, please contact us:

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