Qualified Institutional Buyer (QIB):

What Is It and How Has It Changed?

Introduction

You may be thinking to yourself, "What is a Qualified Institutional Buyer (QIB), and why may it be relevant to me?" Well, I would like to answer those two questions in the most colorful way possible: first giving you some quick notes on the history of the Act within which the definition of a QIB resides and clarifying what the changes to the definition of a QIB may mean to you and the breadth of investments that your account(s) may now hold.

Some Quick Notes on History

Let's turn back the clock approximately 100 years, to the "Roaring 20's". The 1920's saw the birth of commercial radio, the invention of the vacuum cleaner, the electric blender, water skis and the Band-Aid. Alexander Fleming created Penicillin. In Pasadena, California, Lionel Sternberger shook up the culinary world by putting a slice of cheese on a hamburger, thereby creating the "cheeseburger". It was a wonderful time for music as well, headlined by such talents as Fats Waller, Blind Willie Johnson, Bessie Smith and the one and only Louis Armstrong. Jazz was growing in popularity, both within the United States and abroad, as America's entry into World War I had carried this unique brand of music overseas.

The 1920's – for the most part – were also a great time to be invested in the US stock market. The Dow Jones Industrial Average ("DJIA") increased sixfold from the summer of 1921 to September 1929. What everyone was about to learn, however, was that this rally was built on a foundation made of mud. As the market rallied in the mid 1920's, everyone from the very wealthy oil magnates to waiters and gardeners opened accounts at brokerage firms and poured most – if not all – of their assets into the market. Many went as far as taking out mortgages on their homes just to obtain more money to invest. Margin accounts were opened, further adding to the fragility of the overall investment system (by the summer of 1929, it is estimated that 300 million shares of stock were being carried on margin).[1] As the overall systemic risk grew, no warnings were issued by any major institution. Why? Because the markets were overseen at the state level – there was no federal monitoring and oversight of the products and services that supported the markets at this time.

Our economic system survived in this manner because it was consistently being fed additional assets. The moment that inflows significantly slowed into the system, the market began a freefall. This began on October 18th, 1929 and carried forward to the 24th – the day when investors began to panic and sold shares in mass to limit their losses. The major banks and investment companies tried to stem the drop in the market by buying as much of the shares as they could within their proprietary accounts. This plan didn't work, and the panic resumed the following Monday, when the DJIA declined an additional 13%. On Tuesday, October 29th – known as Black Tuesday - the market crashed. By mid-November of 1929, the Dow had lost almost half of its value. This decline culminated in the summer of 1932, when the DJIA closed at 41.22 - the lowest value of the 20th century and 89% below its peak.

[1] https://www.britannica.com/event/stock-market-crash-of-1929

Corrective Measures

When Franklin Delano Roosevelt took over the Presidency in 1932, he brought with him the bundle of legislation known as the New Deal, with the hope of turning our overall economy around. If this economic metamorphosis was going to be successful, one of the primary goals needed to be renewing the country's - and the world's - faith in our financial markets. To do this, federal regulation of the securities markets needed to be implemented. Out of this need came the Securities Act of 1933[2], followed by the Securities Exchange Act of 1934[3] (the Act which gave birth to the U.S. Securities and Exchange Commission).[4]

The Securities Act of 1933's goal was to require much more transparency by publicly-traded companies to investors by requiring the companies to register with the Securities and Exchange Commission (SEC). This registration also required the companies to submit their financial statements. The Act also made such activities as insider trading, the sale of fraudulent securities, and other manipulative stock trading practices / other misrepresentations illegal.

As with any Rule or Act, there are always specific exemptions – and the '33 Act had a few that are relevant to our subject. These exemptions were developed to give companies faster and cheaper access to capital so long as they were only offered to accredited investors deemed sophisticated enough to evaluate the risk.

Rule 144a of the Securities Act of 1933

Rule 144a[5] and Regulation D (finalized in 1982)[6] of the Act allow a company to issue restricted or controlled securities for public resale without registering with the SEC. Since these types of securities do not bring with them nearly the same transparency as registered securities do, the SEC decreed that they could only be purchased or sold by persons / entities that meet or exceed the required minimum criteria of an "Accredited Investor" (Rule 501(a) of Regulation D)[7]. Basically, the SEC wanted to make sure that the people investing in these types of securities offerings had the level of financial sophistication necessary to effectively weigh and measure the risk of buying or selling a privately issued security, as well as the financial stability to handle any type of delays as it pertains to the sale of these securities. So, while those oil magnates we mentioned before may qualify as Accredited Investors…the odds are that those waiters and gardeners that took out mortgages on their homes and invested on margin a few years prior would not.

You may be asking yourself, "if these privately-issued securities carry greater risk because they aren't as transparent as registered securities, then why would I want to invest in them?" Well, these types of securities are not just issued by small firms that are looking to expand – they are also issued by larger, publicly-traded companies.

Within the updated Rule, the SEC says that "In 2019, registered offerings accounted for $1.2 trillion (30.8 percent) of new capital, compared to approximately $2.7 trillion (69.2 percent) that we estimate was raised through exempt offerings. Of this, the estimated amount of capital reported as being raised in offerings under Rule 506(b) and 506(c)[8] of Regulation D was approximately $1.56 trillion."[9] The ability to

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[2] https://www.govinfo.gov/content/pkg/COMPS-1884/pdf/COMPS-1884.pdf
[3] https://www.govinfo.gov/content/pkg/COMPS-1885/pdf/COMPS-1885.pdf
[4] https://www.history.com/topics/us-government/securities-and-exchange-commission
[5] https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html
[6] https://www.sec.gov/smallbusiness/exemptofferings/rule506b
[7] https://www.law.cornell.edu/cfr/text/17/230.501

[8] https://www.sec.gov/smallbusiness/exemptofferings/rule506b
[9] https://www.sec.gov/rules/final/2020/33-10824.pdf

invest in 144a's broadens the portfolio manager's investible universe and increases the manager's capacity to select the best securities to fit clients' risk profiles taking into consideration liquidity requirements.

As the SEC stated within the final version of the updated Rule, "Prior to the adoption of these final rules, in the case of individuals, the accredited investor definition has used wealth – in the form of a certain level of income or net worth – as a proxy for financial sophistication."[10], As you can see, Accredited Investors have historically had access to a much larger pool of investible securities – but the prior definition limited access to these securities simply based on how much in assets you were worth or oversaw.

This now leads to the question…

What's Changed?

The short answer to this question is: several things. Three different rules within the Securities Act of '33 were enhanced as a result of this update – Rule 501(a), Rule 215 and Rule 144a. Let's go through them, one by one.

- **Rule 501(a)** – Originally, this rule elaborated on the definition of an Accredited Investor as either a *Natural Person* that maintained a significant level of income or net worth, or *Regulated Entities* (Banks, Registered Investment Advisers, Registered Broker-Dealers, Insurance Companies and Savings & Loan institutions). The original rule also had an entity designation that was expanded beyond the specific list in the original rule to include a catch-all category. This enhancement to the Rule now includes the following:
  - *Natural Persons*
    - A "spousal equivalent" was added for families that meet the required income and net worth thresholds.
    - Individuals that carry professional certifications, designations, or other credentials (i.e., the CFA® Charter holders) are now considered Accredited Investors.
    - Individuals employed by private funds that would be considered "knowledgeable employees" as defined by Rule 3c-5 of the Investment Company Act of 1940[11] are also now considered to be Accredited Investors.
  - *Regulated Entities*
    - This portion of the definition has been expanded to now include all SEC and state-registered investment advisers and exempt reporting advisers.
  - *Other Entities*
    - The expanded definition now includes a third category, with includes certain family offices (managing assets in excess of $5 million in assets), certain limited liability companies, Rural Business Investment Companies (RBIC's), and 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)[12] 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.

[10] https://www.sec.gov/rules/final/2020/33-10824.pdf
[11] https://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm
[12] https://www.law.cornell.edu/cfr/text/17/270.2a51-1

As we can see, the SEC has expanded the definition of Accredited Investor to include qualifying criteria that takes into consideration the investor's level of investment experience and education.

- **Rule 215**[13]– as per the SEC, "The amendment to Rule 215 replaces the existing definition (of an Accredited Investor) with a cross reference to the definition in Rule 501(a)."[14]
- **Rule 144a[15]** – Here is where the SEC expanded its definition of a Qualified Institutional Buyer (QIB). Under this rule, a QIB now also includes limited liability companies and RBICs if they meet the $100 million in securities owned and invested threshold in the definition. The amendments also add to the list any institutional investors included in the accredited investor definition that are not otherwise enumerated in the definition of "qualified institutional buyer," provided they satisfy the $100 million threshold.

It's important to note here that, even after these changes take effect as of December 8th, 2020, Accredited Investors that are individuals are still **not** considered QIBs, regardless of how wealthy they are or how financially educated / sophisticated they are.

Now we've gotten a basic understanding of the goals of the '33 Act, we've gone over the enhancements made to the definitions of an Accredited Investor and a QIB, and we've briefly discussed the sheer size of the overall bond market that 144a securities currently represent. However, as the primary author of this white paper is a compliance officer, one question immediately comes to mind…

What are the Checks and Balances?

It used to be that, as per Rule 506(b) of Regulation D, an issuer was provided a "safe harbor" to market an unregistered, privately issued security to an unlimited number of Accredited Investors (as well as up to 35 other sophisticated investors), as long as the issuer did not violate any anti-fraud provisions. How were the issuers assured that they complied with this requirement? Well, that was easy: they just needed to self-verify.

Now, under Rule 506(c) of Regulation D, an issuer of this type of security may broadly solicit and generally advertise the offering if all the investors are Accredited Investors, and the **issuer** takes **reasonable steps** to verify that each is accredited.

What is a "reasonable step" for verification purposes? Issuers and resellers need a reasonable belief that the buyer of this type of security qualifies as a QIB. Issuers normally can request the following information from QIBs to ensure compliance:

- Publicly available financial statements
- SEC or other regulatory filings that would evidence the value of assets under management
- Information in a recognized securities manual (i.e., Moody's or S&P)
- A certification signed by the purchaser's CEO or CFO which states the total amount of assets owned or managed as of the recent fiscal year-end.

This information needs to be kept current on the issuer's/seller's books & records (within the past 16 months).

[13] http://www.columbia.edu/~hcs14/R215.htm
[14] https://www.sec.gov/news/press-release/2020-191
[15] https://www.law.cornell.edu/cfr/text/17/230.144A

Conclusion

The definitions of Qualified Institutional Buyers and Accredited Investors have been enhanced and, as a result, investors should reach out to their managers or broker/dealers and determine whether they meet the new definition of a QIB. If an investor confirms that they do fall under this enhanced definition of a QIB, the discussion between them and their manager/broker can evolve into whether including 144a securities fall within the parameters of their investment policy and corresponding risk appetite.

In addition, compliance departments within registered investment advisers ("RIAs") and broker/dealers will need to make sure that the proper adjustments to their policies and procedures are made.

- Firms will need to update their policies and procedures to ensure that they include a process for:
  - Identifying which clients are considered QIBs under the new rule,
  - Periodically documenting confirmations of clients' QIB status, and
  - Ensuring that only qualified accounts as per the updated definitions participate in 144a trading activity.
- Compliance departments of registered investment advisers may also want to consider periodic testing of compliance with these new definitions by selecting a sample of 144a trades over a period of time, to confirm that each client account that received an allocation qualifies as a QIB.
- RIAs should also consider testing compliance with these enhanced definitions as part of the firm's Annual Review process, as required by Rule 206(4)-7 of the Investment Advisers Act of 1940.[16]
- If the RIA utilizes a third-party service provider to periodically evaluate compliance with the firm's policies and procedures, the firm's CCO may want to include testing of 144a allocations as part of the vendor's testing scope.
- Lastly, RIAs may want to consider a review of the firm's trading system to ensure that it is properly coded to exclude any clients that are not considered a QIB under the updated definitions from 144a allocations.

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Questions?

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[16] https://www.sec.gov/rules/final/ia-2204.htm