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A legal update from Dechert's Financial Services Group

Proposed Changes to Regulation D

Introduction

The SEC recently proposed to revise Regulation D to clarify application of the rules and provide additional flexibility to investors. Adopted in 1982, Regulation D sought to simplify and clarify existing exemptions for limited or private offerings, in addition to expanding the availability of such exemptions to certain investors. Regulation D was originally created to facilitate capital formation by small businesses, but is now used by companies of all sizes. The objective of the proposed revisions is to modernize and clarify Regulation D to bring it more in line with the modern market and communications technology, while still providing protection for investors.[1]

The proposed revisions to Regulation D would:

- include a new exemption from registration under the Securities Act of 1933 (the "1933 Act") for "large accredited investors" (proposed Rule 507);
- clarify the definition of the term "accredited investor" to reflect changes in the investment landscape that have happened since the term was originally adopted (proposed Rule 501(a) modifications);
- shorten the timing required by the integration safe harbor under Regulation D (proposed Rule 502(a) modifications); and
- apply uniform disqualification provisions to all Regulation D offerings.

[1] Rel. Nos. 33-8828 and IC-27922 (Aug. 3, 2007)

The SEC is also soliciting comments on revisions to Rule 504 proposed in December 2006 that would make securities sold under that rule "restricted" and would define "accredited natural person" for certain pooled investment vehicles.

The comment period ended on October 9, 2007.

Discussion

Proposed Rule 507

Proposed Rule 507 would create a new exemption to the registration requirements of the 1933 Act for a new category of investors, referred to as "large accredited investors." Rule 507 is based on current Rule 506 but would differ in several substantive ways:

- allow issuers a limited opportunity to advertise the offering;
- create a new "large accredited investor" category;
- in effect, prohibit sales to non-accredited investors;
- provide an exemption under Section 28 rather than Section 4(2) of the 1933 Act; [2] and

[2] As discussed below, Section 28 gives the SEC broad authority, by rule or regulation, to exempt any transaction from any provision of the 1933 Act.

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- designate securities issued in reliance on the new exemption as "covered securities." [3]

Rule 507 would allow issuers to publish a limited announcement of an offering made under the exemption. The announcement would be required to state prominently that the offering is only for "large accredited investors," that no money is being solicited through the offer, and that the securities are being offered pursuant to an exemption from the 1933 Act. At the issuer's option, the announcement may also include a brief description of the issuer, basic information regarding the nature of the securities being offered, the definition of "large accredited investor," contact information for the issuer, and any relevant standard regarding the suitability of the investment.

The publication may only appear in "written form," such as newspapers, magazines, or the Internet. Under no circumstances may radio or television broadcasts or infomercials be used. Additional information may be provided orally or in writing if the issuer reasonably believes that the prospective purchaser is a "large accredited investor." Information may also be provided to prospective purchasers through an electronic database restricted to those investors who qualify under the new "large accredited investor" standard.

The SEC proposed the new category of "large accredited investor" in response to its perceived need for more investor protection where limited advertising is allowed. As is the case under the current "accredited investor" qualification, the new standard would provide separate tests for institutional investors and natural persons. For institutional investors, the new standard would require entities that are currently required to have $5 million in assets to qualify under Rule 501(a) as "accredited investors," to have $10 million in investments to qualify as "large accredited investors" under Rule 507. The $10 million standard for entities and institutions was chosen for its similarity to the "institutional investors" standard in the Uniform Securities Act of 2002, approved by the National Conference of Commissioners of Uniform State Laws.

For natural persons, the new standard requires the individual to either (a) own more than $2.5 million in investments; or (b) have had an income of more than $400,000 ($600,000 if spousal income is included) for the past two years and an expectation of a similar level of income in the future. The natural persons' standards were chosen to both conform with recent SEC proposals ($2.5 million in investments matches the pooled-investment requirement submitted in December 2006) and, in the case of the income standards, reflect inflation since 1982. Those individuals and entities not currently subject to a dollar-amount threshold for "accredited investor" status under Regulation D would qualify as "large accredited investors," including banks, registered investment companies, other regulated entities identified in Rule 501(a)(1) and (2), and directors and executive officers of the issuer.

Any offerings conducted under Rule 507 would be limited solely to "large accredited investors." Although proposed Rule 507 offerings could be conducted simultaneously with another Regulation D offering, those offerings must be considered separate and distinct under the five-factor integration test set forth in Rule 502(a).

The exemption from registration provided in Rule 507 would be adopted pursuant to the SEC's general exemptive authority under Section 28 of the 1933 Act. Section 28 allows the SEC to exempt any transaction from any provision of the 1933 Act "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." The SEC did not propose Rule 507 under Section 4(2) of the 1933 Act, because it viewed the limited advertising allowed under that Rule as incompatible with Section 4(2)'s non-public offering exemption. As a result, pooled investment vehicles relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("1940 Act"), which are required to sell their securities in a non-public offering, would be barred from utilizing the exemption under Rule 507.

In addition, a "large accredited investor" participating in a proposed Rule 507 offering would be defined under Rule 146 as a "qualified purchaser" under Section 18(b)(3) of the 1933 Act, resulting in the preemption of state securities regulation of securities sold in such an offering under the National Securities Markets Improvement Act of 1996 ("NSMIA").

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3 Securities sold under Rule 507 would be covered securities because large accredited investors that purchase them would be "qualified purchasers" under Section 18(b)(3) of the 1933 Act.

Revising the Definition of ''Accredited Investor''

Rule 501(a) currently lists eight categories of individuals and entities that qualify as "accredited investors" for purposes of Regulation D. The SEC proposes to modify the current requirements under Rule 501(a) by:

- adding an alternative "investments-owned" standard to the current asset and income standards;
- defining the term "joint investment" as it applies to natural persons;
- establishing a mechanism to inflation-adjust the dollar-amount thresholds; and
- adding several new categories to the enumerated list.

The SEC has proposed these amendments to both provide clarification and to align the requirements with the changes previously proposed to pooled investment companies in a December 2006 release.[4]

Rule 501(a) currently provides that entities must have in excess of $5 million in total assets to qualify as accredited investors and individuals must have a net worth above $1 million or annual income above $200,000 ($300,000 if spousal income is included). The SEC proposes to add an investment-based qualification as an alternative criterion to the asset- and income-based criteria. For legal entities, the alternative investment standard would be $5 million. For individuals, the alternative investment standard would be $750,000.

The SEC has proposed a definition of "joint investments" to provide a means to calculate investments held by an investor and his or her spouse with respect to the new investment standard. The definition of "joint investment" would provide that an individual seeking to make a Regulation D exempt offering without obtaining the signature and binding commitment of his or her spouse could only include 50% of any investments held jointly with the spouse and any investment in which the individuals share a community property or similar interest with the spouse. Where both spouses sign and are bound by the investment document, the full amount of their shared investments may be counted. To provide further clarification, the terms "joint net worth" and "joint income," currently used to define the existing asset and income standards, would be changed to "aggregate net worth" and "aggregate income," respectively, to make clear the distinction from the "joint investment" definition.

Starting in July 2012, and every five years thereafter, the dollar-amount thresholds set forth in Rule 501 will be inflation-adjusted to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce. The adjusted dollar amounts will be rounded to the nearest $10,000. The dollar-amount thresholds are being inflation-adjusted to prevent the accredited investor standards from becoming eroded over time, thereby allowing more unsophisticated investors to engage in risky, unregistered offerings. Additionally, by tying the standards to inflation, the SEC has sought to avoid raising the standards so high that issuers forego the safe harbor of Regulation D for offering under the general exemption of Section 4(2).

Currently, Rule 501(a)(3) includes a list of legal entities that may qualify as accredited investors, subject to certain conditions. The list includes organizations described in Section 501(c)(3) of the International Revenue Code, corporations, Massachusetts or similar business trusts, and partnerships. The current proposal would amend the list to include any

- corporation (including non-profit corporations);
- Massachusetts or similar business trust;
- partnership;
- limited liability company;
- Indian tribe;
- labor union;
- governmental body; or
- other legal entity with substantially similar legal attributes.

[4] Rel. No. 33-8766 (Dec. 27, 2006)

Revisions to the General Conditions of Regulation D

SEC also seeks to make two changes to rules regarding integration and disqualification under Regulation D. Under the current integration safe harbor in Rule 502(a), offers and sales of securities made either six months prior or six months after a Regulation D offering are not be considered part of the same offering. The SEC would shorten this time frame to 90 days.

According to the SEC's Advisory Committee on Smaller Public Companies, the current six month requirement "represents an unnecessary restriction on companies that may very well be subject to changing financial circumstances, and weighs too heavily in favor of investor protection, at the expense of capital formation." While the Advisory Committee's recommendation advocated shortening the timetable to 30 days, the SEC believes that the 90-day requirement would provide the necessary flexibility identified by the Advisory Committee while preserving the purpose of the integration rule, namely that issuers do not seek to evade registration requirements by having numerous exempt offerings during a short time span.

The SEC proposal would also implement a general "bad actor" disqualification provision for all offerings under Regulation D. Rule 502(e) would address what the SEC sees as a problem with recidivism in problematic Regulation D offerings, and the pre-emption of state laws which, prior to NSMIA, would disqualify such recidivists issuers. Only Rule 505 currently provides any kind of disqualification provisions, essentially incorporating the disqualification provisions of Rule 262 under Regulation A, by reference, which disqualifies various actors who have "committed relevant violations of laws and regulations."

Rule 502(e) would apply to any issuer, predecessor or affiliate of the issuer, director, executive officer, general partner or managing member of the issuer, beneficial owner of at least 20% of any class of issuer's securities, and any promoter connected with the issuer. Notably, underwriters are not included in the affected group, because the SEC determined they do not have enough control or influence over the issuer to warrant inclusion. Rule 502(e) would have six disqualification provisions, each relying on a determination by a government official or agency, or self-regulatory organization, that the relevant person had engaged in wrongdoing. Proposed Rule 502(e) would prevent the use of offering exemptions under Regulation D where the issuer or covered persons:

- filed a registration statement within the last 5 years that is the subject of an injunction or administrative stop order;
- was convicted of a criminal offense within the last 10 years in connection with the offer, purchase or sale of securities, or involved making a false filing with the SEC;
- has been subject within the last 5 years to an adjudication or determination by a federal or state regulator of a violation of securities, commodities, or similar laws;
- is subject to an order, judgment, or decree by a court, within the last 5 years, that restrains the person from engaging in conduct involving securities or similar businesses;
- is subject to a cease and desist order within the last 5 years issued under federal or state securities laws; and
- is subject to suspension or expulsion from a national securities exchange or national securities association for an act/omission constituting conduct inconsistent with just and equitable principles of trade.

In order to create a unified rule, the disqualification provisions found in current Rule 507 would be removed and replaced with a clause in proposed Rule 502(e). A safe harbor would also be created for those issuers that neither knew, nor could have reasonably known, that the disqualification existed.

Conforming Revisions

The proposal would revise Rule 215's definition of "accredited investor" to conform with the definition under Rule 501(a). Additionally, the preliminary notes to Rule 144A would be revised to make clear that the general announcement allowed in a proposed Rule 507 offering would preclude resales under Rule 144A.

Conclusion

The SEC's proposals appear to reasonably clarify the application of the current rules and would provide additional flexibility to investors.

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