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The Securities and Exchange Commission Proposes Revisions to Regulation D

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Introduction

In an effort to facilitate capital formation while still protecting investors, on August 3, 2007, the Securities and Exchange Commission ("SEC") proposed revisions to liberalize reliance on Regulation D. Regulation D provides exemptions from the registration requirements of the Securities Act of 1933 ("Securities Act") for the offers and sales of securities in private or limited offerings. In Release No. 33-8828, the SEC has proposed several changes that will clarify Regulation D and provide flexibility and greater access to capital while still maintaining investor protection. The proposed revisions, if implemented, would generally increase the number of investors who will qualify as accredited investors and shorten from six months to ninety days the waiting period between offers and sales made in reliance on Regulation D. The SEC has proposed adding a new Rule 507 for the sales of securities to "large accredited investors," amending the definition of "accredited investor" by adding an alternative "investments-owned" standard and a dollar-amount inflation adjustment, shortening the Regulation D integration safe harbor time frame, and creating uniform disqualification provisions for all Regulation D offerings.

Background: Regulation D Generally

Regulation D provides an exemption from the registration requirements of the Securities Act for private or limited offerings and sales of securities. As long as certain conditions are met, companies selling securities pursuant to the Regulation D exemptions will not have the burden of complying with the registration requirements of the Securities Act because generally there is less of a need for investor protection due to the sophistication of involved investors. Regulation D Rules 504, 505 and 506 provide the exemptions. In general, Rule 504 exempts companies that are not subject to reporting requirements under the Securities Exchange Act of 1934 for the offer and sale of up to $1,000,000 of securities in a 12-month period. Rule 505 provides an exemption for offers by companies of up to $5,000,000 of securities in a 12-month period, but the offers cannot be made with general solicitation or advertising. Finally, Rule 506, which has no limitations on the offering amount, exempts offers made without general solicitation or advertising as long as sales are made only to "accredited investors" and a limited number of non-accredited investors who satisfy an investment sophistication standard.

New Rule 507: Exemption for Limited Offers and Sales to "Large Accredited Investors"

In Release No. 33-8828, the SEC proposed to create a new exemption to the registration requirements of the Securities Act. This exemption, set forth in a new Rule 507, would be limited to sales of securities to "large accredited investors" and would permit limited, tombstone-like advertising in connection with such offerings. The "large accredited investor" standard would be based upon the "accredited investor standard," but with higher dollar-amount thresholds. Legal entities that constitute accredited investors if their assets exceed $5,000,000 would be required to

have $10,000,000 in investments to qualify as large accredited investors. Individuals would be required to own $2,500,000 in investments or have an annual income of $400,000 ($600,000 with a spouse) to qualify as large accredited investors, as compared to the accredited investor standard of $1,000,000 in net worth or $200,000 in annual income ($300,000 with a spouse). The basis for the proposal is that such investors or entities are better able to protect themselves without the protection that the Securities Act registration requirements provide due to the general increased sophistication and financial literacy of investors in today's markets, coupled with the advantages of modern communication technologies.

Like Rule 506, proposed Rule 507 would not have a limit on the offering amount or on the number of investors who meet specified criteria. While Rule 506 allows sales to up to thirty-five non-accredited investors, all Rule 507 sales must be to only "large accredited investors." Unlike Rule 506, Rule 507 requires investors to meet the heightened "large accredited investor" standard. Instead of the total ban on general solicitation and general advertising pursuant to Rule 506, Rule 507 issuers could engage in limited advertising with certain conditions, including stating that sales will be made only to "large accredited investors" and sales are made pursuant to an exemption. Although such limited advertising may include information such as a brief description of the issuer's business in twenty-five or fewer words and a brief description of the securities being offered (including the name, type, number, price and aggregate amount of securities being offered), such limited advertising can only be in written form. Such written form could occur in any written medium, such as in a newspaper or on the Internet.

Proposed Revisions Related to the Definition of "Accredited Investor"

The SEC proposed adding an alternative "investments-owned" standard, with a threshold of $750,000 for individuals and $5,000,000 for institutions, to the "accredited investor" definition found in Rule 501(a). This "investments-owned" standard would not include the value of personal residences and places of business because such real estate is not considered to be held for investment purposes. To avoid effectively lowering the threshold in terms of real purchasing power, this alternative standard would include an adjustment for inflation to the dollar-amount thresholds beginning on July 1, 2012, with an adjustment every five years thereafter.

The SEC also proposed defining the term "joint investments" to mean that investments of an individual who seeks to make an investment in a Regulation D exempt offering without obtaining a binding commitment of his or her spouse may include only fifty percent of any investments held jointly with the individual's spouse and any investments in which the individual shares a community property or similar shared ownership interest with the individual's spouse.

To reduce uncertainty and promote more efficient private capital formation, the SEC proposed adding several categories of permitted entities to the list of accredited and large accredited investors. The Rule 501(a)(3) list of legal entities would include any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body or other legal entity with substantially similar legal attributes.

Finally, the SEC proposed establishing a new category of "accredited investor," an "accredited natural person," which individuals would need to satisfy to invest in certain private pooled investment vehicles pursuant to Rule 506. An "accredited natural person" would have to qualify as an "accredited investor" and would have to own at least $2,500,000 in "investments."

Shortening the Regulation D Safe Harbor Time Frame

The integration doctrine prevents an issuer from improperly avoiding registration by dividing a single offering into multiple offerings such that an exemption would apply to each of the multiple offerings that would not be available for the combined offering. Rule 502(a) provides an integration safe harbor. Formerly, the integration safe harbor provided that offers and sales more than six months before a Regulation D offering or more than six months after the completion of a Regulation D offering would not be considered part of the same offering. The SEC has proposed shortening the Regulation D safe harbor time frame from six months to ninety days, meaning that investors would only have to wait ninety days to make offers and sales pursuant to Rule 502(a). In Release No. 33-8828, the SEC stated

that the six month time period "weighs too heavily in favor of investor protection, at the expense of capital formation." In particular, six months could inhibit smaller companies from meeting their capital needs.

Creating Uniform Disqualification Provisions for All Regulation D Offerings

Currently under Regulation D, only Rule 505 provides disqualification provisions. To deter bad actor recidivists from relying on Regulation D exemptions, particularly in light of the proposed increases in flexibility in preparing and conducting private offerings, the SEC proposed creating uniform disqualification provisions for past misconduct for all Regulation D offerings. The disqualification provisions pursuant to proposed Rule 502(e) would apply to the issuer, any predecessor of the issuer and any affiliated issuer; any director, executive officer, general partner or managing member of the issuer; any beneficial owner of twenty percent or more of any class of the issuer's equity securities; and any promoter connected with the issuer. The six disqualification provisions would preclude reliance on Regulation D exemptions where the issuer or covered person:

- filed a registration statement within the last five years that is the subject of a currently effective permanent or temporary injunction or an administrative stop order;
- was convicted of a criminal offense in the last 10 years that was in connection with the offer, purchase or sale of a security or involved the making of a false filing with the SEC;
- has been subject to an adjudication or determination within the last five years by a federal or state regulator of a violation of federal or state securities or commodities law or a law under which a business involving investments, insurance banking or finance is regulated;
- is subject to an order, judgment or decree by a court entered within the last five years that restrains or enjoins the issuer or a person from engaging in any conduct or practice involving securities and other similar businesses, including an order for failure to comply with Rule 503 (the filing of Form D);
- is subject to a cease and desist order entered within the last five years issued under federal or state securities or similar laws; or
- is subject to a suspension or expulsion from membership in or association with a member of a national securities exchange or national securities association for an act or omission constituting conduct inconsistent with just and equitable principles of trade.

The length of disqualification from reliance on a Regulation D exemption is generally five years, but the SEC proposed disqualification for ten years for more egregious conduct resulting in criminal conviction. Proposed Rule 502(e)(2) also would provide a safe harbor for an offering by an issuer if that issuer establishes that it did not know and reasonably could not have known that the disqualification existed.

Proposed Revisions to Rule 504

Finally, the SEC proposed revisions to Rule 504, the Regulation D exemption limited to offers and sales of securities up to $1,000,000. The revisions would require securities sold in reliance on the Rule 504 exemption and pursuant to state law exemptions that permit general solicitation and advertising if sales are made exclusively to accredited investors, to be deemed "restricted securities." Currently, securities sold in reliance on Rule 504(b)(1)(iii) are not subject to limitations on resale and, as such, are not "restricted securities" for purposes of Rule 144. An amended Rule 144 would generally allow such securities to be resold only after a 12-month holding period. This proposal is designed to deter abusive practices involving Rule 504 offerings such as "pump and dump" schemes for securities of non-reporting companies that trade over the counter.

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