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September 2010 - Rule 506 Offerings - Revised Net Worth Requirement for "Accredited Investors"

Section 4(2) of the federal Securities Act of 1933 provides a transactional exemption from registration for non-public offers and sales of securities by an issuer. Rule 506 of SEC Regulation D provides a safe harbor for claiming the Section 4(2) exemption. Although the Rule limits sales to a maximum of 35 purchasers, so-called "accredited investors" are excluded from the tally. Moreover, while issuers must always disclose all facts material to their offerings to comply with anti-fraud provisions, sales to "accredited investors" may be made without adhering slavishly to detailed, line-item information requirements that otherwise apply. Finally, under Section 18 of the Securities Act, securities sold in compliance with Rule 506 are "covered" by federal law and the underlying transactions may not be regulated by the states. The ability to offer and sell securities to an unlimited number of "accredited investors" without incurring the expense of registration, providing unnecessary disclosure or subjecting the offering to state regulation is a linchpin of the capital raising efforts of cash-strapped private issuers.[1]

In general, Regulation D treats investors as "accredited" if (a) they are regulated financial or securities entities (e.g. banks, registered investment companies, insurance companies, stock brokerage firms, etc.); (b) they have ready access to information about the offering because of their relationship to the issuer (e.g., as a director, partner or executive officer); or (c) they meet financial standards for earnings, total assets or, if natural persons, net worth. This Bulletin concerns a change in the net worth standard.

Until recently, natural persons could qualify as "accredited" if, at the time they purchased the securities, their net worth, individually or jointly with spouse, exceeded $1,000,000 *inclusive of all assets*. On July 21, 2010, however, the federal "Dodd-Frank Wall Street Reform and Consumer Protection Act" took effect. Section 413 of that statute directs the SEC to "adjust" the net worth standard so as to *exclude* from the calculation the *"value"* of the *"primary residence"* of the natural person. The dollar threshold is to remain $1,000,000 for four years. At the end of that period, and thereafter at four year intervals, the SEC may adjust the threshold or otherwise modify the definition of "accredited investor" under its rule making authority. In making adjustments, the SEC is instructed, without elaboration, to take "the economy" into account while pursuing its traditional objectives of promoting the public interest and protecting investors.[2]

The Securities Division of Washington's Department of Financial Institutions has initiated expedited rule-making to conform its definition of "accredited investor" to the new federal standard. Comments on the proposed rules are due October 19, 2010. Adoption is assured and the other states will follow suit.[3]

Obviously, this change will not enhance the lives of entrepreneurial executives. Home equities remain the most valuable asset listed by many investors who claim to be accredited, even though residential values are both inherently subjective and currently depressed. The immediate effect of the new threshold, therefore, will be to reduce significantly the number of investors who can plausibly qualify as

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[1] For a study of the transactional exemptions from registration provided by the Securities Act and the safe harbors provided by Regulation D see, www.hutchins-law.com/publications: *"Private Placements – Parts I-IV."*

[2] This new twist on an old directive might be amusing in another context, but in the current economic climate it's more than a little disconcerting. In a recession, should the threshold be kept artificially low to stimulate the economy notwithstanding any conflicting public interest in the integrity of the capital markets? Does the objective of protecting investors vary directly with the consumer price index, but inversely with the unemployment rate? Such questions are best left to others, but I'd feel better about Dodd-Frank if either the Congress or the SEC knew something about the economy.

[3] See, www.dfi.wa.gov/securites for links to Dodd-Frank and the proposed Washington Rules.

"accredited." That, in turn, will force Rule 506 issuers to plan increasingly for offerings limited to as few as 35 purchasers. Here are some possible responses for companies seeking capital under the Rule:

√ Break the financing into tranches offered at 6 month intervals.

Accreditation issues aside, the first step for the issuer in any offering is to identify all potential investors known to its representatives who appear intellectually able to understand the offering and financially able to invest in it with discretionary funds. Even if the issuer can identify *no one* who is clearly accredited, it can divide its total capital requirement into components, or "tranches," each of which can be filled with relatively modest investments by no more than 35 unaccredited purchasers. For most issuers, this is both feasible and a good selling point. It is rarely the case that an issuer must receive all desired funds at once. Businesses develop in phases and typically require capital only incrementally. A financing plan divided into like phases can attract initial investors by providing enhanced equity or convertible debt interests commensurate with early-stage risk. Follow-on investors can be protected by ensuring that their capital commitments will not be called until the milestones for them have been reached.[4]

If more than 6 months elapses between the closing date for any given tranche and the beginning of the selling period for the next one, each tranche will be treated, for the purposes of Rule 506, as a separate offering which may be sold to up to 35 non-accredited purchasers. For example, assume a small issuer estimates it will need between $4,750,000 and $5,000,000 over two years to carry out an expansion plan, but will require no more than $1,225,000 in any six month period. The issuer could offer a total of $4,900,000 in securities. The securities could be sold in four $1,225,000 tranches separated by 6 month intervals. Each tranche would be limited to a maximum of 35 non-accredited purchasers and the securities would be sold in lots of $35,000. By the end of the two years, the issuer could raise its $4,900,000 by selling securities to as many as 140 investors none of whom need be "accredited." Moreover, in practice there will usually be at least some investors whose accredited status is obvious.[5]

As a separate offering, each tranche must comply with the securities laws in its own right. Even so, the overall disclosure burden should not increase unacceptably merely because the desired capital is raised in phases. No matter how its offering is structured, an issuer's duty to disclose material facts continues until its investors have determined whether to purchase the securities. Pending that determination, unanticipated adverse events, if material, must be disclosed promptly on discovery and current financial statements must be furnished as prepared. Thereafter, as a matter of sound practice if nothing else, issuers should provide updated information to security holders in the normal course of business.

√ Don't overlook the other qualifications for "accredited" status.

As stated, banks, savings and loan associations and insurance companies are accredited, though they do not typically invest in small private companies. On the other hand, regulated Small Business Investment Companies and private business development companies are also accredited and actively seek such

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[4] Issuers can offer securities without registration to anyone with whom its directors, officers, managers or other representatives have an existing "substantive" relationship, whether familial, professional, business or social. If the representatives are experienced in business, the number of potential investors they may lawfully solicit can be surprisingly large. See, www.hutchins-law.com/publications: *"Private Placements Part II - Finding Investors, Selling Constraints Applicable to Unregistered Securities Offerings."*

[5] Notwithstanding any lack of accreditation, however, all investors in a Rule 506 offering must be "sophisticated," i.e., able to understand the issuer, its business and the rights and limitations of the offered securities. This does not mean the investors must be able to understand, say, collateralized debt obligations when the offered securities are common shares. But issuers should have a reasonable basis for believing, and should actually believe, that the investors they solicit have sufficient experience in business and financial matters to comprehend the disclosure on their own or with the help of a qualified "purchaser representative." See, *"Private Placements Part II, etc*.," Note 4.

investments. Registered stock brokers are accredited and both invest in and act as placement agents for private issuers. Corporations, partnerships and limited liability companies are accredited, even though not specially regulated, if they have at least $5,000,000 in total assets or are owned entirely by persons who themselves are accredited. Charitable organizations defined in Section 501(c)(3) of the Internal Revenue Code and business trusts are accredited if they meet the $5,000,000 in assets threshold. Employee benefit plans can qualify as accredited on any of several grounds: For example, a corporate plan is accredited if it has in excess of $5,000,000 in total assets or its investment decisions are made by a bank, savings and loan association, insurance company or registered investment adviser that qualifies as an ERISA plan fiduciary. A self-directed plan is accredited if its investment decisions are made by accredited investors or it meets the $5,000,000 total assets test. Finally, and perhaps most importantly, natural persons with $200,000 in income for each of the last two years ($300,000 with spouse) and a reasonable expectation of reaching the same income level in the current year are not only accredited, but fairly easy to find.

√ Don't overlook the other "excluded" purchasers.

Accredited investors are not the only persons excluded from the 35 purchaser maximum imposed by Regulation D. Any relative, spouse or relative of the spouse of a purchaser with the same principal residence as the purchaser is also excluded, as is any trust, estate, corporation or other organization more than 50% of the equity of which is owned, collectively and beneficially, by those related persons. I regularly encounter offerings in which a major portion of the aggregate investment is made by excluded spouses, self-directed retirement plans or controlled business organizations. Importantly, organizations with multiple owners count as only one purchaser if not formed specifically to invest in the securities.

√ Review the investors' questionnaires before accepting their money.

Issuers commonly determine accreditation using questionnaires in which investors provide, and warrant as accurate, basic information about their business experience, investment history and objectives, risk tolerance and financial status. The resulting self-certification is effective if properly utilized, but unfortunately some issuers accept the completed questionnaires without reviewing the answers, with disastrous results. An issuer's belief in the accredited status and sophistication of its investors must have a reasonable basis in fact; a requirement not lost on securities regulators or plaintiffs' counsel. Review all questionnaires carefully before depositing investors' funds or accepting their subscription agreements.

√ Adapt the disclosure to the company, its business and the securities; not the investors.

Avoid the mistake of justifying cursory disclosure by purporting to offer securities exclusively to accredited investors. That practice is fraught with risk. Securities claims are brought with the benefit of hindsight following a failed investment. No issuer can be certain of persuading a court or jury that it sold its securities only to qualified purchasers or that it could not have foreseen and disclosed the adverse events that caused its business to fail. Make the necessary disclosures. To avoid overkill, take advantage of Rule 502(b)(2) of Regulation D, which provides that an issuer must furnish specified information, but only "to the extent material to an understanding of the issuer, its business and the securities being offered." All business is associated with material financial risk. Sophisticated investors, accredited or not, expect full disclosure of that risk and issuers should not hesitate to provide it.

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