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SEC Proposes Liberalization of Private Placement Requirements

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On August 3, 2007, the Securities and Exchange Commission ("SEC") proposed a series of actions which, for the most part, would have the effect of liberalizing private placement requirements. The proposed actions would modify the safe harbor for private placements provided by Regulation D as follows:

- Creation of a new safe harbor for offerings to "Large Accredited Investors" where limited publicity would be permitted in the offering
- A modest expansion and clarification of the categories of investors who would qualify as "Accredited Investors"
- Addition of inflation adjustments to increase over time the minimum standards for Accredited Investors and Large Accredited Investors
- Shortening from six months to 90 days the time needed between private placements to avoid integration
- Implementation of a modified statutory disqualification provision which would prevent companies with a history of certain legal problems from taking advantage of any of the safe harbors provided by Regulation D

In addition, although not a rule proposal, the SEC provided important guidance which may facilitate private placements after a registration statement has been filed by an issuer.

In its Release (#33-8828), the SEC seeks comments on these proposals, as well as a number of other prospective changes to Regulation D. Comments are due on or before October 9, 2007.

Background

The Securities Act of 1933 ("Securities Act") provides that, unless otherwise exempt, all offers and sales of securities in the United States must be registered with the SEC. If a claim of exemption is asserted, the burden lies on the person asserting the exemption to establish its availability. The primary statutory provision exempting private placements by issuers is Section 4(2) of the Securities Act, which exempts transactions "not involving any public offering." The uncertain scope of Section 4(2) vexed companies and their counsel for many years and led the SEC in 1982 to adopt Regulation D.

Regulation D provides a non-exclusive safe harbor for private placements. As currently in force, Regulation D provides three distinct safe harbors which are available to issuers who comply with the applicable requirements. Of the three current provisions, Rule 506 has been the most broadly used because it contains no limitation on the amount of money which may be raised in the private placement and no limitation on the number of Accredited Investors who may participate in the offering. Moreover, there are no explicit disclosure requirements for Rule 506 private placements sold exclusively to Accredited Investors.

"Accredited Investors" is currently defined to include, among others, individuals with a net worth in excess of $1 million or with individual income in excess of $200,000 (or joint income with a spouse in excess of $300,000). Prospective investors are permitted to include the equity in their residence in calculating net worth. As a result of inflation, especially in the value of real estate in certain markets, the percentage of American households qualifying as Accredited Investors has increased from approximately 1.64% of all households in 1982 when

Regulation D was adopted, to 8.47% of all households today. A similar trend has expanded the availability of Accredited Investor status for corporations and other legal entities who generally qualify if they have total assets of at least $5 million.

Reflecting its concern about the apparent erosion in the Accredited Investor standard, the SEC proposed late last year to raise the minimum thresholds for natural persons investing in private pooled investment vehicles such as private equity funds. These suggested changes generated substantial controversy. In this latest Release, the SEC has left open the possibility of raising the threshold for natural persons who invest in private pooled investment vehicles. However, the SEC is not proposing to raise the threshold for investors in private placements by other issuers, such as most companies that are engaged in a primary business other than that of investing.

New Safe Harbor for Large Accredited Investors

The SEC has proposed the adoption of Rule 507, which would create a new non-exclusive safe harbor for Large Accredited Investors. As with Rule 506, issuers could raise an unlimited amount of money under Rule 507 and could sell their securities to an unlimited number of Large Accredited Investors. Rule 507 private placements could only be sold to Large Accredited Investors. In this respect, Rule 507 would differ from Rule 506, which permits sales to up to 35 Non-Accredited Investors. The SEC noted that since Rule 506 prohibits the use of general solicitation and advertising and Rule 507 is limited exclusively to sales to Large Accredited Investors, neither Rule 506 nor Rule 507 offering would be available if the two offerings were considered as integrated where one offering used limited public advertising and the other offering was sold to persons who were not Large Accredited Investors. Offerings under Rule 507, like offerings under Rule 506, would be "covered securities" and therefore exempt from substantive regulation at the state level.

The most important change from established practice is that, under proposed Rule 507, the issuer would be permitted to publish a notice regarding the private placement. This would be a significant departure from the requirements of Rule 506, which prohibits any general solicitation in the conduct of the private placement. The proposed notice could include the name of the issuer, a description of the offering, a summary description of the issuer (not to exceed 25 words), information on investor suitability requirements, and contact information to obtain more information about the private placement. Through such a notice, an issuer conducting a Rule 507 private placement could effectively reach out to new prospective investors with whom it had no prior contact. By contrast, the requirements of Rule 506 largely limit issuers to selling to investors with whom the issuer or its agents have a pre-existing relationship.

"Large Accredited Investors" would be defined as legal entities with at least $10 million of investments and natural persons with at least $2.5 million of investments or with an annual income of at least $400,000 ($600,000 if joint income with a spouse). A new definition of "investments" would be added to Regulation D and would generally include securities, real estate, commodities, cash accounts, financial contracts, and the cash surrender value of insurance policies. Residential real estate occupied by the investor or a family member and real estate owned to conduct a trade or business would be excluded from the definition of "investments." Similarly, securities issued by a company controlled by the investor would be excluded from "investments" unless the underlying company is a public company or has shareholders' equity of at least $50 million. For joint investments or investments held as community property, both spouses would be required to sign the subscription documentation in order to include 100% of the value of such investments; if only one person signs, then only 50% of the value of such joint investments could be counted in determining the investor's total "investments."

Changes to the Definition of "Accredited Investor"

As noted above, the new SEC proposal would not immediately raise the thresholds for qualification as an Accredited Investor. In fact, the proposal would modestly expand the scope of natural persons who qualify as Accredited Investors by adding an "investments" alternative to the net worth and income tests currently contained in the definition. Under the new investments test, a natural person would qualify as an Accredited Investor if such person has at least $750,000 of investments. The definition of "investments" would be the same as described above under Rule 507.

The definition of "Accredited Investor" would also be modified to clarify that limited liability companies, non-profit corporations, labor unions, governmental bodies, government-sponsored retirement plans, and similar entities may be Accredited Investors if they meet the $5 million asset test.

Future Inflation Adjustments

The SEC has proposed that the minimum net worth, assets, income, and investment thresholds for qualification as an Accredited Investor be subject to automatic adjustment in the future based on inflation. The adjustments would take place every five years, with the first adjustment scheduled for 2012. The adjustments would be calculated based on changes in the Personal Consumption Expenditures Index published by the Department of Commerce.

Shortening the Time Frame Between Private Placements

Companies that seek to raise capital on a recurrent basis through private placements need to be careful lest their private placements be integrated into a single offering which does not qualify as a private placement. Regulation D currently has a safe harbor which provides that private placements will not be integrated if there is a six-month gap between the end of one private placement and the beginning of another. Under the latest proposal, the SEC would shorten that time frame to 90 days.

Restricting Use of Regulation D by Securities Law Violators

Of the three safe harbors currently contained in Regulation D, only one (Rule 505) is unavailable to companies that are disqualified because of past misconduct. The SEC now proposes to adopt a uniform "bad boy" provision which would prohibit any of the disqualified parties from using the safe harbors provided by Regulation D.

Under this proposal, if the issuer, its predecessor, an affiliate, or any director, executive officer, general partner, managing member, promoter, or 20% shareholder had been involved in certain legal proceedings, then that issuer would not be eligible to rely upon Regulation D. The prior conduct that would result in such disqualification includes: (i) a criminal conviction within the last 10 years under the securities laws, (ii) having filed a registration statement within the last 5 years that is the subject of a currently effective injunction or stop order, (iii) adjudication within the last 5 years that the person violated securities, commodities, investment, insurance, banking, or finance laws, (iv) the person is the subject of a judgment entered by a court, or a cease-and-desist order entered by an administrative agency, within the last 5 years, enjoining or prohibiting any conduct related to securities or a similar business, or (v) the person was suspended or barred from association with a firm that is a member of the NASD or a stock exchange.

Liberalization of Private Placements During Public Offerings

The Release includes statements by the SEC which appear to liberalize the ability of companies to conduct private placements concurrently with the pendency of a registered offering. Generally speaking, because the filing of a registration statement has been deemed to constitute general solicitation, the SEC staff has held that a concurrent private placement would not be possible while the registration statement was in review by the SEC or in use by the issuer following effectiveness. The primary exception to this position has been the *Black Box* ruling, which permitted a concurrent private placement to a limited number of large institutional investors.

In the Release, the SEC states that it would be possible to conduct a concurrent private placement if the issuer can establish that participants in the private placement were not in effect solicited by means of the registration statement. This would permit concurrent private placements to be sold to a broader range of private investors, provided that the issuer carefully documents how each investor was solicited. This interpretation may be of particular interest to issuers involved with PIPE transactions who may need to raise additional capital even as they are registering for resale shares issued in a prior PIPE transaction.