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News Bulletin

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One Down, One to Go: The SEC Completes the First Required Dodd-Frank Act Regulation D Rulemaking

The Securities and Exchange Commission (the "SEC") recently completed the first of two Regulation D rulemakings mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The Dodd-Frank Act modified the net worth standard included in the definition of "accredited investor" under the Securities Act, as well as directed the SEC to adopt amendments disqualifying the offer or sale of securities in Rule 506 offerings by certain felons and similarly situated bad actors. In December 2011, the SEC adopted amendments to the net worth standard, with those changes effective on February 27, 2012.[1] Meanwhile, the agency now expects to adopt amendments providing for disqualifications with respect to felons and bad actors in the first half of 2012.[2]

Final Amendments to the New Worth Standard

As contemplated by Section 413(a) of the Dodd-Frank Act – which was effective upon enactment on July 21, 2010 – the SEC has amended the net worth standard included in the "accredited investor" definition specified in Securities Act Rules 215 and 501 to now exclude the value of an individual's primary residence from the calculation used to determine if the individual (either alone, or jointly with the individual's spouse) qualifies as an "accredited investor" on the basis of having a net worth in excess of $1 million, as measured at the time of exempt sale of the security to the individual.

Before the enactment of the Dodd-Frank Act, an individual could include the value of his or her primary residence when calculating net worth. In an era of rapidly rising home values, some became concerned that the net worth standard became too easy to achieve, and these concerns ultimately resulted in the enactment of Section 413(a) of the Dodd-Frank Act, which immediately removed the value of a person's primary residence from the net worth calculation. Since that time, market participants have been relying on guidance provided by the staff of the SEC's Division of Corporation Finance to determine how to exclude the value of the primary residence, particularly when the primary residence secures a mortgage debt.[3]

[1] Release No. 33-9287 (December 21, 2011) (the "Adopting Release"). The Adopting Release is available at http://www.sec.gov/rules/final/2011/33-9287.pdf.
[2] Rules were proposed in accordance with Section 926 of the Dodd-Frank Act in Release No. 33-9211 (May 25, 2011) (the "Bad Actor Proposing Release"). The Bad Actor Proposing Release is available at http://www.sec.gov/rules/proposed/2011/33-9211.pdf.
[3] Securities Act Rules Compliance & Disclosure Interpretation, Question No. 255.47 (July 23, 2010), available at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#255.47.

The final rules do not define the term "primary residence" for the purpose of this exclusion. Rather, the SEC indicated in the Adopting Release that this term has "a commonly understood meaning as the home where a person lives most of the time."

Under the rules as amended, debt secured by an individual's primary residence, up to the estimated fair market value of the residence, will not be treated as a liability when determining if the individual's net worth exceeds the $1 million threshold. On the other hand, debt secured by the primary residence that is in excess of the estimated fair value of the primary residence is treated as a liability under the amended rules. In order to address the concerns expressed by certain commenters that the rules could have the unintended consequence of encouraging borrowing secured by one's primary residence for the purpose of qualifying as an accredited investor, the SEC adopted a provision which requires that any increase in the amount of debt secured by the primary residence that is incurred in the 60 days before the sale of securities must be included as a liability in the net worth calculation, even in those circumstances where the estimated fair market value of the primary residence continues to exceed the aggregate amount of debt secured by the primary residence. This inclusion of newly secured debt as a liability in the net worth calculation does not apply in a situation where the new debt was incurred as a result of acquiring a primary residence.

Grandfathering Net Worth Calculations

In order to ease the transition to the amended rules in the case of pre-existing purchase rights, the pre-Dodd-Frank Act net worth standard will continue to apply to any calculation of an individual's net worth (when the individual would not qualify under the new test) made in connection with a purchase of securities in accordance with a pre-existing purchase right if: (1) the individual held the purchase right on July 20, 2010, the day immediately prior to the enactment of the Dodd-Frank Act; (2) the individual qualified as an accredited investor on the basis of satisfying the net worth standard at the time the purchase right was acquired; and (3) the individual held securities of the same issuer, other than the purchase right, as of July 20, 2010.

The grandfathering provision applies specifically in the context of (i) statutory rights, such as state-law imposed pre-emptive rights; (ii) rights that arise under an issuer's organizational documents; and (iii) rights established by contract, for example rights to acquire securities of an issuer upon the exercise of an outstanding option or a warrant or upon the conversion of a convertible security, rights of first refusal or first offer, as well as contractual pre-emptive rights.

The Future of the Net Worth Standard

Section 413(a) of the Dodd-Frank Act tasks the SEC with undertaking a review of the accredited investor definition as it applies to natural persons, and reviewing the definition in its entirety every four years, beginning in 2014, four years after the July 2010 enactment of the Dodd-Frank Act. In the course of reviewing the accredited investor definition, the SEC must ascertain whether the requirements should be modified for the protection of investors, in the public interest, and in light of economic conditions.

Presently, it should be noted that the SEC's amendments to the net worth standard are for the most part consistent with the statutory language and the above-referenced staff implementation guidance. Issuers should revisit their offering documents, including investor questionnaires and representations included in other offering documents, in order to ensure that those documents are consistent with the rule as revised, including the impact of the grandfathering provision and the 60-day look-back provision that was not initially contemplated by statute and the SEC staff's implementation guidance.

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The Future of Regulation D Rulemaking

With the net worth standard rules now adopted, the SEC can turn its attention to the proposed disqualifications with regard to felons and similarly situated bad actors in Rule 506 offerings, proposed back in May 2011. The SEC has received a number of comment letters on the Bad Actor Proposing Release, raising many complex issues in the implementation of the proposed bad actor and felon disqualifications for the most widely used private offering safe harbor. The SEC's Dodd-Frank implementation timetable now contemplates that these rule changes implementing Section 926 of the Dodd-Frank Act will be adopted in the first half of 2012.

Moreover, as legislative activity has recently focused attention on restrictions with respect to communications in connection with private offerings, and in particular the ban in Rule 506 offering on general solicitation and general advertising, the SEC is moving forward with efforts to examine the general solicitation ban and more generally the regulation of offers in private offerings. We expect that, in the near future, the SEC may issue a concept release soliciting comment on these issues, and more changes to Regulation D may result from any of these SEC and legislative private offering reform initiatives.

Contacts

David Lynn
(202) 887-1563
dlynn@mofo.com