
# The Dodd-Frank Act's Impact on Private Securities Offerings

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On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law. While the sweeping legislation is primarily aimed at large financial institutions that are deemed to be systemically important, smaller financial institutions and non-financial institutions are also affected in significant ways, including, by way of example, the Dodd-Frank Act's impact on private securities offerings. This article first discusses the new accredited investor standard that was mandated by the Dodd-Frank Act. Next, this article discusses the proposed Securities and Exchange Commission ("SEC") rules that will, as required by the Dodd-Frank Act, disqualify certain "bad actors" from relying on the frequently used securities registration exemption provided by Rule 506 of Regulation D.

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## I. Accredited Investor Standard

### a. Background

The accredited investor standards, which are set forth in Rules 215 and 501 of the Securities Act of 1933 (the "Securities Act"), are used by issuers of securities in determining the availability of certain exemptions from Securities Act registration, primarily for private offerings. Rule 501 defines the term "accredited investor" for purposes of the Regulation D safe harbor exemptions (Rules 504, 505, and 506). Accredited investors do not have to be counted for purposes of determining the 35-purchaser limit of Rules 505 and 506, and, if sales made pursuant to Rules 505 or 506 are made only to accredited investors, no specified disclosure document has to be used. As the SEC noted in its adopting release (the "release") (Release Nos. 33-9287; IA-3341; IC-29891: December 21, 2011), Regulation D (and thus Rule 501) is frequently and primarily relied upon for private offerings, while reliance on the exemption to which Rule 215 relates is rare.

Under both Rules 215 and 501, the definition of "accredited investor" includes persons that fall within any of the listed categories (or whom the issuer reasonably believes come within one of those categories) at the time such person purchases securities. One of the categories is the individual net worth standard. Prior to the enactment of the Dodd-Frank Act, the individual net worth standard provided that any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of that person's purchase exceeded $1,000,000 was an accredited investor. Although "net worth" was not defined in the Securities Act, it was commonly understood to mean the excess of total assets, less total liabilities, in each case including those relating to the investor's primary residence.

Effective as of July 21, 2010, Section 413(a) of the Dodd-Frank Act changed the individual net worth standard for purposes of the Securities Act to exclude from one's assets, the value of a person's primary residence and charged the SEC with implementing rules reflecting this requirement. The SEC subsequently issued guidance on July 23, 2010 that, in calculating net worth under this new standard, an investor may also exclude the amount of any indebtedness secured by his or her primary residence, up to the fair market value of the residence. The final rule issued by the SEC on December 21, 2011, adopts amendments to the individual net worth accredited investor standard in order to (i) codify the changes required by the Dodd-Frank Act and the SEC's guidance regarding the same and (ii) provide further rules and guidance regarding the new standard, specifically with respect to the treatment of mortgage debt and limited grandfathering and transition matters (the "amendments"). The amendments became effective February 27, 2012.

### b. Amendments

#### i. Primary Residence and Mortgage Debt

As noted above, a most significant change under the new standard is that an individual investor may not include any positive equity he/she may have in his/her primary residence as an asset in calculating his/her net worth. The SEC specifically declined to define "primary residence," and instead noted in the release that such term has a commonly understood meaning as the home where a person lives most of the time.

One of the primary areas of further clarification and rule making in the amendments relates to the treatment of mortgage debt in the net worth calculation. As a general matter, indebtedness that is secured by the primary residence is not included as a liability when calculating net worth. However, there are two exceptions to this general rule.

First, mortgage indebtedness that is in excess of the estimated fair market value of the primary residence is included as a liability. The SEC received comments that excess mortgage debt should not be included as a liability in the net worth calculations if the borrower would not be subject to personal liability. The SEC rejected this view in the release and stated that it believed the full amount of the debt incurred by an investor is the most appropriate value to use in determining accredited investor status, since it is the basis upon which interest accrues and third parties would look in assessing creditworthiness. Thus, excess mortgage debt is included in the net worth calculation whether or not the lender can seek repayment from the purchaser's other assets in default. (Note: In determining the value of the primary residence (as well as any other assets and liabilities) investors are not required to obtain a third party opinion on valuation. Rather, all that is required is an estimate of fair market value for such assets or liabilities.)

Second, increases in the amount of debt secured by the primary residence that are incurred in the 60 days before the sale of securities to the investor will be included as a liability in the net worth calculation. This is the case even if the estimated fair market value of the primary residence continues to exceed the aggregate amount of debt secured by the residence. The SEC stated in the release that it believes this look-back provision is necessary to prevent investors from artificially inflating their net worth by borrowing against their primary residence and converting their positive home equity (which would be excluded from the net worth calculation) into cash or other assets (which would be included in the net worth calculation). The 60-day look-back period will not apply to debt that was incurred as a result of the acquisition of the residence.

#### ii. Transition and Grandfathering

In adopting the amendments, the SEC determined that grandfathering and other transition relief (*e.g.*, for issuers in the midst of an ongoing offering; or investors that intended to make follow-on investments as part of an investment plan) generally was not necessary or appropriate. Thus, the SEC has drawn a fairly bright-line rule: the previous accredited investor standard (as modified by the Dodd-Frank Act) will apply to all sales of securities made before February 27, 2012, and the new standard as reflected in the amendments will apply to all sales of securities made on or after such date. There is, however, one limited grandfathering exception. The amendments allow an investor who is not an accredited investor under the new net worth standard to use the previous net worth standard if (i) the investor is purchasing securities in accordance with a right to purchase such securities (*e.g.*, pre-emptive rights under state law; rights arising under an issuer's constituent documents; or contractual rights, such as options, warrants, convertible instruments, rights of first offer or refusal, or anti-dilution rights), (ii) the right was held by the person on July 20, 2010 (the day before the enactment of the Dodd-Frank Act), (iii) the person qualified as an accredited investor under the prior net worth standard at the time the right was acquired, and (iv) the person held securities of the same issuer (other than the right in question) on July 20, 2010.

#### iii. Future Review

Section 413(b) of the Dodd-Frank Act requires that, every four years, the SEC review the definition of "accredited investor", as it relates to natural persons. In conducting such review, the SEC is to determine whether the definition should be adjusted or modified "for the protection of investors, in the public interest, and in light of the economy".

## II. Bad Actor

### a. History

Rule 506 of Regulation D is a "safe harbor" for the private offering of securities under the Securities Act. In order to be within the safe harbor, the issuer, among other things, cannot use general solicitation or advertising to market the offering; must limit the offering to no more than 35 non-accredited investors; and must provide any non-accredited investors certain financial information about the issuer and confirm that such investors have (either alone or with a representative) sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the proposed investment. Unlike Rules 504 and 505 (the other exemptive rules under Regulation D), issuers using the Rule 506 exemption can raise an unlimited amount of capital in the offering, which is one of the primary reasons that, according to the proposed rules (defined below), Rule 506 is the most widely used Regulation D exemption and accounts for the overwhelming majority of capital raised under Regulation D.

Other areas of the Securities Act (*e.g.*, Regulation A and Rule 505) contain "bad actor" disqualification requirements that prohibit issuers and others from participating in offerings if they have committed certain specified bad acts, such as securities fraud. In its current form, Rule 506 contains no such bad actor disqualifications. It is also important to note that, because Rule 506 offerings preempt state laws, any state-level bad actor disqualification rules that would otherwise be applicable do not apply to Rule 506 offerings.

Section 926 of the Dodd-Frank Act, entitled "Disqualifying felons and other 'bad actors' from Regulation D offerings" requires the SEC to adopt bad actor disqualification requirements that apply to Rule 506. Section 926 instructs that the SEC adopt disqualification rules that are substantially similar to those set forth in Rule 262 of Regulation A, as well as adopt certain additional disqualification triggering events that are not currently contemplated by Rule 262. As of the date this article was submitted for publication, the SEC was estimating that final Section 926 rules will be adopted in the first half of 2012.

### b. Proposed Amendments

On May 25, 2011, the SEC proposed amendments to Regulation D to implement Section 926 of the Dodd-Frank Act (the "proposed rules") (Release No. 33-9211: May 26, 2011). The proposed rules would be codified as a new paragraph (c) of Rule 506, and some of the highlights of the proposed rules include the following:

#### i. Covered Persons

The first critical element of the proposed rules is the list of persons that would be covered by the disqualification provisions ("covered persons"). The SEC proposes that the following persons be covered persons:

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.

This list is substantially the same as the current list under Rule 262. Of note, however, the SEC expresses concern in the proposed rules that the breadth of the term "officer" (defined as "a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization") could present significant challenges, particularly with respect to large financial institutions participating in the offering as placement agents, broker-dealers, finders, and advisors. The SEC notes that these firms may have a large number of employees that fall within this definition, many of whom are not involved in the offering and that, given the reasonable care requirements of issuers described below, could result in issuers expending significant time and resources attempting to comply with this proposed rule. Accordingly, the SEC has sought comment on whether covered persons should be limited to "executive officers", those officers "actually involved with the offering", or in some other manner; or whether the broad category in the proposed rule is justified because it would provide investors with greater protection.

The SEC also sought comment as to whether the proposed coverage of 10% equityholders is appropriate, or whether the threshold for covered persons should be increased or only applied to those persons that have a control stake in the issuer.

**ii. Disqualifying Events**

The second critical element of the proposed rules is the list of events and circumstances that give rise to disqualification if committed by a covered person ("disqualifying events"). The proposed rules would generally mirror the disqualifying events currently covered by Rule 262, which includes:

• Felony and misdemeanor convictions in connection with the purchase and/or sale of a security or involving the making of a false filing with the SEC with the last five years in the case of issuers and ten years in the case of other covered persons;

• Injunctions or court orders within the last five years against engaging in or continuing conduct or practices in connection with the purchase or sale of securities, or involving the making of any false filing with the SEC;

• U.S. Postal Service false representation orders within the last five years;

• Filing, or being named as an underwriter in, a registration statement that is the subject of a proceeding to determine whether a stop order should be issued, or as to which a stop order was issued within the last five years; and

• For covered persons other than the issuer:

- being subject to an SEC order:

• revoking or suspending their registration as a broker, dealer, municipal securities dealer, or investment adviser;

• placing limitations on their activities as such;

• barring them from association with any entity; or

• barring them from participating in an offering of penny stock; or

- being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a national securities association for conduct inconsistent with just and equitable principles of trade.

In addition, the proposed rules would expand the Rule 262 list to include the following disqualifying events mandated by the Dodd-Frank Act:

• Final orders issued by state securities, banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either:

- bar a person from association with an entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance, or banking, or from savings association or credit union activities; or

- are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within a ten-year period; and

• Felony and misdemeanor convictions in connection with the purchase and sale of a security or involving the making of a false filing with the SEC.

Under the proposed rules, each of the above disqualifying events would generally relate to all covered persons, whereas, under Rule 262, certain disqualifications apply only to certain covered persons. Also, unlike Rule 262, which measures the look-back periods from the date the requisite offering filing is made with the SEC, the proposed rules would measure from the date of each sale for which the Rule 506 exemption is sought. Given that many Rule 506 offerings are on-going, multi-year offerings, this will require issuers to continuously monitor their compliance with the proposed rules.

**iii. Other – Proposals**

In addition to the two most critical elements described above, the SEC proposes certain other amendments in the proposed rules to address potential implementation and compliance issues.

(1) Reasonable Care

In an attempt to balance the burden on issuers of ascertaining whether disqualifications apply – particularly in light of the broad definition of "officers" and the lack of a public, central repository that would allow an issuer to determine whether a covered person has a disqualifying event in his or her past – and the issuers' responsibility to screen bad actors out of their Rule 506 offerings, the SEC proposes a "reasonable care" exception. Under this proposal, an issuer would not lose the benefit of the Rule 506 safe harbor, despite a disqualifying event by a covered person, if the issuer can establish that it did not know, and, in the exercise of reasonable care, could not have known, that a covered person had committed a disqualifying event. To establish reasonable care, the issuer must conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the situation (*e.g.*, the likelihood that bad actors could be present; the presence of other screening and compliance mechanisms; and the cost and burden of the inquiry). The SEC indicates that the factual inquiry of the covered persons themselves – through questionnaires, for example – may be sufficient in some circumstances.

(2) Waivers

The proposed rules also provide that the SEC may grant a waiver from the disqualifying rules if it determines that the issuer has shown good cause as to why the disqualifying rules should not apply. The SEC did not, however, provide guidance on circumstances that are likely to give rise to the grant or denial of a waiver.

(3) Form D Amendments

Finally, the proposed rules would include a conforming amendment to Form D that would require issuers claiming a Rule 506 exemption to confirm that the offering is not disqualified from reliance on Rule 506 under the new rules.

**iv. Other – Proposals Not Included**

The following issues that are not addressed in the proposed rules are almost as important as the amendments that are proposed.

(1) Grandfathering

The SEC proposes not to exempt or "grandfather" potentially disqualifying events that occurred before the enactment of the Dodd-Frank Act. Thus, under the proposed rules, the disqualification provisions would apply to all sales made under Rule 506 after the effective date of the proposed rules, and all offerings would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back period, in each case without regard to whether the disqualifying event occurred before the enactment of the Dodd-Frank Act. The proposed rules would not affect any offerings that closed, or transactions that were completed, before the effective date.

The SEC sought comment as to whether certain market participants would be unfairly impacted by the new rules. Specifically, it notes in the proposed rules that some participants may have entered into negotiated settlements prior to the enactment of the Dodd-Frank Act that would now, under the proposed rules, prohibit them from participating in Rule 506 offerings, and that such persons may have settled on different terms, or not at all, if they knew the settlement would result in disqualification from Rule 506.

(2) On-going Offerings

The SEC also proposes not to provide different treatment to offerings that are open and on-going at the time of the effective date of the proposed rules. And further proposes not to measure the disqualifying rules only at the time of the commencement of a Rule 506 offering, but rather at the time of each sale made in connection with that offering. Therefore, with respect to an on-going offering, the disqualification rules will apply to any sales made after the effective date. This could pose significant and unexpected compliance costs and delays for issuers in the midst of a Rule 506 offering, as they attempt to identify each of their covered persons, and confirm that none of them have disqualifying events. Moreover, if the disqualifying rules do apply, issuers will be faced with difficult business decisions (*e.g.*, parting ways with an officer that has a disqualifying event or registering the offering) and contractual issues (*e.g.*, query the impact on an exclusive placement agent arrangement if a covered person of the placement agent has a disqualifying event).

(3) Transition Period

Finally, the SEC has not proposed any transition or phase-in period. Thus, as noted above, issuers may be faced with unexpected delays, as they halt their offerings to confirm that they are not disqualified from relying on Rule 506.

## III. Conclusion

The new accredited investor definition and the proposed bad actor provisions have significant impacts on issuers, investors, and their counsel.

With respect to the new accredited investor definition, counsel to issuers who rely on the accredited investor definition, such as issuers engaged in Rule 506 offerings, should be certain to update their investor questionnaires and subscription agreements to reflect the new definition. In addition, if follow-on investments are contemplated, such as a capital call in the private equity context or the exercise of preemptive rights, whether the follow-on investment would be considered the exercise of a right that existed on July 20, 2010, or a new investment, should be analyzed. Finally, counsel to high net worth individual investors should re-evaluate whether such individuals still qualify as accredited investors that can continue to participate in the same manner in private offerings.

With respect to the bad actor disqualification provisions, which were still in proposed format on the date this article was submitted for publication, counsel to issuers contemplating or conducting a Rule 506 offering may want to begin preliminary bad actor compliance now so as to avoid potential lengthy delays upon enactment. Items to consider include beginning the waiver process if the covered person who is a bad actor is vital to the offering and exploring other potential offering exemptions – keeping in mind state "bad actor" rules. In addition, contracts with service providers, such as third-party placement agents, involved in the offering, as well as covered persons of the issuer, should contain termination provisions tied to the proposed bad actor rules.

Finally, as with any area of law, practitioners should stay alert for further changes to the Securities Act arising from the Dodd-Frank Act. For example, the SEC is currently considering whether to (i) apply the new Rule 506 disqualifying rules to any other offering exemptions that are not subject to "bad actor" provisions at this time (*e.g.*, Rule 504), (ii) modify all existing "bad actor" provisions (*i.e.*, Regulation A and Rule 506) to conform to the new Rule 506 provisions, and (iii) propose a uniform look-back period of ten years for any disqualifying events that have an express look-back period.