THE FINANCIAL BANKING REFORM BILL: TURNING BACK THE CLOCK ON PRIVATE PLACEMENT EXEMPTIONS

by Robert E. Braun and Craig Levine, 05/06/10

The "Restoring American Financial Stability Act of 2010" (the "Bill") currently winding its way through Congress has been labeled by some as an attempt to address many of the weaknesses in the U.S. financial system which contributed to the recent economic downturn. While the scope and ultimate fate of the Bill is very much in flux, the Bill would charge regulators with the task of monitoring systemic risks to the economy, create a new bureau of consumer financial protection within the Federal Reserve and enact sweeping new rules to govern the derivatives market.

Many of these changes will have significant, long-term impacts on capital markets and the banking industry. However, buried within the 1400-plus pages of the Bill are three provisions which would drastically impact small investors and startup companies. These provisions would particularly affect venture capitalists and angel investors.

As originally described in the Bill (S. 3217) reported to the Senate on April 15, 2010, these provisions would:

- Increase the financial thresholds for individuals qualifying as "accredited investors" (e.g., those investors whose investments are not subject to certain information requirements imposed by federal securities regulations);
- Grant the Securities and Exchange Commission ("SEC") the power to make certain financing transactions which are currently preempted from state regulation subject to such regulation; and
- Require that those offerings that remain preempted from state regulation nonetheless be subject to a 120 day review process with the SEC.

ADJUSTING ACCREDITED INVESTOR THRESHOLDS

Since 1982, when the SEC adopted Regulation D, the safe harbor for private offerings, an individual has been considered "accredited" if he or she has a net worth of $1,000,000, or either an individual annual income in excess of $200,000, or a combined annual income with his or her spouse of $300,000, in each case in each of the two most recent years. Sales of securities to such "accredited investors" are largely unregulated at the federal level, and if such sales qualify under Rule 506 they are preempted from virtually all state regulation (although certain notices may be required).

The sale of securities in Rule 506 offerings to "accredited investors" has been a frequently-used means for individuals wealthy enough to safely bear the risk of unregistered investments to invest in speculative start-up companies.

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Under the Bill, as reported to the Senate on April 15, 2010, these "accredited investor" financial thresholds (which were originally established in 1982 with the adoption of Regulation D) would be prospectively adjusted for inflation. As a result, the net worth threshold would be readjusted from $1,000,000 to approximately $2,300,000 excluding primary residence and income threshold would be adjusted up from $200,000 to $450,000. In addition, the Bill would have required an adjustment every 5 years.

After receiving complaints about how these increases could stifle investment, reports have surfaced that (i) the net worth standard for an accredited investor would remain at $1,000,000 but that such threshold would exclude the value of a person's primary residence, and (ii) the SEC would be charged with reviewing these thresholds to determine whether adjustment is required.

PREEMPTION CHANGES AND SEC REQUIREMENT TO REVIEW FILINGS

As important as the changes to the accredited investor definition, the Bill would also permit states to impose their own set of regulations on securities offerings, something that is currently preempted for exempt sales under Rule 506. Among other impacts, it seems clear that this move away from Regulation D (which covers the vast majority of offerings exempt from registration) would increase compliance costs on businesses that would be forced to comply with the patchwork of state securities regulations which would replace Regulation D.

As proposed in the Bill approved by committee, the SEC would also be required to review all accredited investor offerings within 120 days of the filing with the SEC. If the SEC did not undertake that review in time, states would be free to impose their own rules.

This waiting period is in stark contrast to the current rules, which require the filing with the SEC of a Form D no later than 15 days after the first sale of covered securities. Now, however, companies would need to file a notice with the SEC prior to such sales and allow the SEC to have 120 days to review such filing. If the SEC fails to review a filing, the security wouldn't be considered a "covered security" exempt from the scrutiny of state securities regulators.

Moreover, language in the Bill which states that the SEC "may designate, by rule, a class of securities that it deems not to be covered securities because the offering of such securities is not of sufficient size or scope" may result in the SEC charging state regulators with the task of reviewing notices for smaller financings.

If adopted, these changes will feel to some like a return to the pre-1982 period before the Regulation D safe harbor brought clarity to companies and investors and the pre-1996 period when Congress preempted state securities laws by adding Section 18(b)(4)(D) to the Securities Act of 1933 (the "1933

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Act") through the passage of the National Securities Market Improvement Act of 1996. One result of these reforms could be that companies deprived of the safe harbor would need to independently conclude whether their offering was covered by Section 4(2) of the 1933 Act, which exempts "transactions by an issuer not involving any public offering."

Recent reports have suggested that the preemption language and 120-day notification requirement may be scrapped in favor of a new proposal which requires disqualifications for bad actors. This would direct the SEC to issue rules for the disqualification of offerings and sales of securities involving individuals who are "bad actors" (e.g., persons with a prior record of violations of certain federal or state laws).

CONCLUSION

Only time will tell how the final Bill which is passed by Congress and presented to the President for signature will look. In the meantime, we at JMBM (along with our clients and colleagues in the venture capital community) will be watching the debate closely.

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