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Recently Enacted Dodd-Frank Financial Reform Legislation Has Immediate Effect on Private Offerings of Securities

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which was signed into law on July 21, 2010, has an immediate effect on many private securities offerings. Specifically, the Act revises the net worth test for determining whether an individual investor is an "accredited investor" for purposes of Regulation D and Section 4(6) of the Securities Act of 1933 (the "Securities Act").

Regulation D is the exemption under the federal securities laws that many issuers, including venture capital firms and real estate and private equity funds, rely upon to raise capital from investors in non-public offerings. This exemption is also often relied upon in many non-public M&A transactions in which the acquiror uses its stock as acquisition consideration. Section 4(6) is a statutory exemption available for private placements solely to accredited investors.

Section 413 of the Act requires the SEC to make a change to the net worth test contained in the definition of "accredited investor" that is applicable to all offerings exempt under Regulation D (especially Rule 506) and Section 4(6) of the Securities Act. **Under the net worth test, an investor must have (either individually or together with the investor's spouse) more than $1 million of net worth at the time of the purchase.** As amended by Section 413 of the Act, the value of the investor's primary residence is now **excluded** from the calculation of net worth. The SEC has indicated in a Compliance & Disclosure Interpretation ("C&DI") dated July 23, 2010 that the amount of any indebtedness secured by the principal residence should be netted from the value of the residence (except where the amount of the debt exceeds the fair market value of the residence and the lender has recourse to the investor personally for such excess, in which case such excess liability is deducted from net worth).

The SEC has clarified in a 2009 C&DI that the net worth test is only applicable to individual investors and not to entities. The SEC has also indicated in the July 2010 C&DI that this change was deemed to have taken effect on July 21, 2010 upon the enactment of the law. Thus, public companies, as well as private companies or other entities, currently conducting an offering pursuant to Regulation D or Section 4(6) of the Securities Act to accredited investors are immediately affected by this change.

Any issuer that is currently relying on these exemptions should immediately reflect this change in the terms of the private placement and the related offering documents, including but not limited to, making the appropriate modifications to subscription or purchase agreements, investor questionnaires or other disclosure documents to adequately reflect this change prior to closing.

Furthermore, issuers conducting a private offering in reliance on Regulation D or Section 4(6) should reassess the accredited investor status of all individual investors under the new net worth test if the old net worth test was relied upon. If an investor fails to meet the amended

net worth test and does otherwise qualify for accredited investor status, the issuer would need to determine whether the investor's participation in the offering as a non-accredited investor would result in a loss of the exemption or whether another exemption from registration may be available. If no exemption is available, the investor would need to be prohibited from purchasing securities in the offering.

Further, for continuous offerings to accredited investors that have already commenced, issuers should determine whether they need to supplement their offering materials and reassess investors' compliance with the new net worth standard, where such standard was originally relied upon.

The change in the definition of "accredited investor" may also affect compliance with state securities laws for states that rely upon or incorporate the federal definition in state law or regulations.

Section 926 of the Act also requires the SEC to issue rules amending Rule 506 to impose a number of "bad boy" disqualifications in relying upon the exemption. These disqualifications would bar reliance of Rule 506 by an issuer if, among others, the issuer (and its predecessors or affiliated issuers), as well as its officers, directors, 10% or greater stockholders, promoters and underwriters (and affiliates of underwriters), have been convicted of certain crimes or subject to certain legal and other proceedings stemming from activities in the securities, banking, insurance or credit union industries. This change to Rule 506 must be implemented by July 21, 2011 by SEC rulemaking. Additional information will be provided on those changes when such rules are made available, but when adopted, these changes will require issuers to undertake significant additional due diligence of their own principals and others associated with a private offering before relying on the Rule 506 exemption. ■

Public Companies and Capital Formation Group

Any person who has a question regarding the issues raised in this *Corporate and Securities Update* may obtain additional guidance from a member of our Public Companies Group (www.blankrome.com).

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