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SEC Proposes Amendments to Regulation D and Form D

Regulation D provides an exemption from the registration requirements of the Securities Act for private or limited offerings of securities. In particular, Rule 506 of Regulation D provides an exemption for offers and sales that are made only to accredited investors and a limited number of non-accredited investors without general solicitation or advertising. Form D serves as the official notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D or Section 4(6) of the Securities Act. In order to clarify and modernize these rules without compromising investor protection, the SEC has proposed the following significant amendments to Regulation D and Form D for public comment:

- adding to Regulation D new Rule 507, which would permit sales of securities to "large accredited investors" and allow limited advertising in connection with such offerings;
- amending the definition of "accredited investor" in Rule 501(a) to, among other things, (i) add an alternative "investments-owned" standard and (ii) establish a mechanism to adjust the dollar-amount thresholds for future inflation;
- shortening from six months to 90 days the period during which Regulation D offers and sales of securities would be integrated with other exempt offerings of the same or similar classes of securities under the integration safe harbor;
- establishing uniform disqualification provisions for all Regulation D offerings; and
- creating an interactive electronic filing system to replace the paper filing for Form D.

In addition, in December 2006, the SEC proposed two new rules under the Securities Act that would establish a new category of accredited investor, "accredited natural person," that would apply to offers and sales of securities under Rule 506 of Regulation D by certain "private investment vehicles." The SEC is currently considering comments received with respect to the December 2006 Release and is soliciting further comments on the proposed amendments.

The comment period for the proposed amendments to Form D expires on September 7, 2007, and the comment period for the proposed amendments with respect to Regulation D, including further comments on the December 2006 Release, expires on October 9, 2007.

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Proposed Rule 507 – Exemption for Limited Offers and Sales to Large Accredited Investors

Proposed Rule 507 would create a new exemption from the registration requirements of the Securities Act by permitting offers and sales of securities to a new category of investors entitled "large accredited investors." Proposed Rule 507 would also permit limited advertising of these offerings. An offering under proposed Rule 507 would share the following characteristics with an offering under existing Rule 506:

- the sale by an issuer of an unlimited amount of securities to an unlimited number of investors who meet specified criteria (accredited investors in the case of Rule 506 transactions and large accredited investors in the case of proposed Rule 507 transactions);
- the availability of the proposed Rule 507 exemption would focus on the characteristics of purchasers rather than offerees;
- proposed Rule 507 would not restrict the payment of commissions or similar transaction-related compensation;
- proposed Rule 507 would be a non-exclusive exemption, except that an issuer engaging in the limited advertising permitted by proposed Rule 507 may not be able to claim a Section 4(2) exemption if the advertising has imparted a public character to the offering;
- securities acquired in a transaction under proposed Rule 507 would be subject to the limitations on resale under Rule 502(d) and therefore considered to be "restricted securities" as defined in Rule 144(a)(3)(ii);
- the issuer would be required to exercise reasonable care to assure that the purchasers of the securities are not underwriters; and
- the issuer would have an obligation to file with the SEC a notice of sales on Form D.

The proposed Rule 507 exemption would, however, differ from the Rule 506 exemption in the following significant ways: (i) the "large accredited investor" standard, (ii) permitted limited advertising, (iii) prohibition on sales to persons who do not qualify as large accredited investors, (iv) authority for the exemption, and (v) "covered security" status.

The "Large Accredited Investor" Standard

The proposed definition of "large accredited investor" is substantially based on the definition of "accredited investor" but with higher dollar-amount thresholds or with a significant "investments-owned" standard. As proposed, the definition of "large accredited investor" provides that an "accredited investor" could qualify as a "large accredited investor" if the following conditions are met, as applicable:

- entities or institutions that currently must have more than $5 million in assets to qualify for "accredited investor" status under Rule 501(a)(1), (3), or (7) would instead be required to have more than $10 million in investments;
- individuals described in Rule 501(a)(5) or (6) would be required to own more than $2.5 million in investments (or joint investments with spouse) or have had an individual annual

income of more than $400,000 (or $600,000 joint annual income with spouse) in the last two years and expect to maintain the same income level in the current year; and

- entities in which all of the equity investors are currently accredited investors, as required by Rule 501(a)(8), would instead be required to be entirely owned by large accredited investors.

The dollar-amount thresholds in the definition of large accredited investor would adjust for inflation every five years commencing on July 1, 2012.

Permitted Limited Advertising

Proposed Rule 507 would permit an issuer to publish a limited announcement of an offering provided that it states prominently that (i) sales will be made to large accredited investors only, (ii) no money or other consideration is being solicited or will be accepted through the announcement, and (iii) the securities have not been registered with or approved by the SEC and are being offered and sold pursuant to an exemption. In addition, an issuer may also choose to include in the announcement any of the following: (a) the issuer's name and address, (b) a brief description of the issuer's business in 25 or fewer words, (c) the name, type, number, price, and aggregate amount of securities being offered and a brief description of the securities, (d) a description of the meaning of the term "large accredited investor", (e) a discussion of any suitability standards and minimum investment requirements for prospective investors, and (f) the name, postal or e-mail address, and telephone number of a person to contact for additional information.

The announcement may only be "in written form" including in newspapers or the Internet and may not include radio or television broadcasts or infomercials. Proposed Rule 507 would allow an issuer or person acting on the issuer's behalf to provide additional information only if the issuer reasonably believes the prospective investor to be a large accredited investor. Such additional information may be provided orally or in writing, including in the form of an offering circular, and may be delivered through an electronic database accessible only by large accredited investors.

Prohibition on Sales to Persons Who Do Not Qualify as Large Accredited Investors

In contrast to Rule 506, under which issuers are permitted to sell securities to up to 35 non-accredited investors and an unlimited number of accredited investors, proposed Rule 507 would permit issuers to sell securities only to large accredited investors. An offering under proposed Rule 507 could be conducted "side-by-side" with another Regulation D offering only if the two offerings would be considered as separate and distinct under the five-factor integration test set forth in Rule 502(a). Because Rule 506 prohibits the use of general solicitation and advertising and Rule 507 is limited exclusively to sales to large accredited investors, neither of these two exemptions would be available if two offerings were integrated because one offering used limited public advertising and the other offering was sold to persons who were not large accredited investors.

Authority for the Exemption

Proposed Rule 507 would be an exemption from the registration provisions of Section 5 of the Securities Act under the general exemptive authority in Section 28 of the Securities Act, which permits the exemption of any transaction to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. The Rule 507 exemption is proposed pursuant to Section 28 of the Securities Act, rather than Section 4(2) of the Securities Act, which exempts transactions by issuers not involving a public offering, because the SEC has historically viewed any advertising as incompatible with a non-public offering under Section 4(2). The Rule 506 exemption on the other hand was promulgated pursuant to Section 4(2) of the Securities Act. Because Rule 507 exemption is not proposed pursuant to Section 4(2) of the Securities Act, private investment vehicles that rely on the exclusion from the definition of "investment company" provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be able to take advantage of the limited announcement under the proposed Rule 507 exemption. This is because such private investment vehicles are required to sell their securities in transactions not involving a public offering (i.e., pursuant to the Section 4(2) exemption).

"Covered Security" Status

State securities regulation of securities designated as "covered securities" is generally limited under Section 18(b) of the Securities Act to requiring notice filings of offerings, requiring the filing of a consent to service of process, and assessing a filing fee. Pursuant to Section 18(b)(4)(D) of the Securities Act, securities sold in transactions exempt under Section 4(2) of the Securities Act (such as offerings under Rule 506) are "covered securities". The proposed amendments to Rule 507 would include large accredited investors in the definition of the term "qualified purchaser" for purposes of Section 18(b)(3) of the Securities Act. Because securities sold to qualified purchasers are deemed "covered securities," securities sold under proposed Rule 507 would be considered "covered securities" as well.

Proposed Revisions Related to the Definition of "Accredited Investor"

The proposed amendments would also revise the definition of the term "accredited investor" in Rule 501(a), which sets forth categories of persons who qualify as an accredited investor. The revisions to the Rule 501(a) "accredited investor" qualification standards would affect the exemptions under Rules 504 through 506, as well as proposed Rule 507 because the definition of a "large accredited investor" is based to a significant extent on the "accredited investor" definition. The revisions would (i) add an alternative "investments-owned" standard for qualification as an accredited investor under Rule 501(a), (ii) define the term "joint investments," (iii) establish a mechanism to adjust the dollar-amount thresholds for future inflation, and (iv) add several categories of permitted entities to the list of accredited investors. If the proposed amendments are adopted, subscription agreements, investor questionnaires and other investor documentation for private placements relying on Rules 504 through 506 would need to be revised to reflect the proposed changes.

Alternative "Investments-Owned" Standard

Rule 501(a) currently provides generally that certain legal entities may qualify as accredited investors if they have total assets in excess of $5 million and that individuals and their spouses may qualify as accredited investors if they have either a net worth above $1 million or annual income above $200,000 (for individual qualification) or combined annual income above $300,000 (for qualification of an individual and his or her spouse). The proposed amendments would add an additional and alternative method of establishing accredited investor status standards based on investments owned by the prospective investor.

For legal entities required to satisfy a $5 million assets test, the proposed amendments would add an alternative investments-owned standard of $5 million. For individuals and their spouses, the proposed amendments would provide a new alternative standard of $750,000 in investments that could be used instead of the current net worth standard of $1 million or annual income standards of $200,000 (or $300,000 with spouse). In determining whether an investor meets the threshold under the investments-owned standard, the value of real estate that is not held for investment purposes, including personal residences and places of business, would be excluded. This approach represents a departure from the historical practice (which is not affected by the proposed amendments) of including personal residences and places of business as assets in calculating total assets for legal entities and net worth for individuals.

Proposed Definition of "Joint Investments"

Regulation D currently allows issuers to count all of the assets that an individual owns jointly with a spouse or that are part of a shared community interest in the calculation of an individual's net worth for purposes of the $1,000,000 net worth standard in the definition of accredited investor in Rule 501(a). The proposed amendments would take a different approach with respect to the alternative investments-owned standard and include in the definition of "joint investments" only 50% of any investments held jointly with the individual's spouse and any investments in which the individual shares a community property or similar shared ownership interest with the individual's spouse. Where spouses both sign and are bound by the investment documentation, the full amount of their investments (whether made jointly or separately) would be included for purposes of the investments-owned standard in the definition of accredited investor in Rule 501(a).

Future Inflation Adjustments

The proposed amendments would adjust for inflation all dollar-amount thresholds set forth in the definition of accredited investor in Rule 501(a) to reflect inflation, starting on July 1, 2012 and continuing every five years thereafter.

Adding Categories of Entities to the List of Accredited and Large Accredited Investors

Rule 501(a)(3) currently includes a list of legal entities that may qualify as accredited investors. The exclusion of certain types of entities, including limited liability companies, from this list has created uncertainty as to whether these types of entities may qualify as accredited investors. In order to address this uncertainty, the proposed amendments would revise the list of

entities in Rule 501(a)(3) so that it includes any corporation (including any non-profit corporation), Massachusetts or similar business trust, partnership, limited liability company, Indian tribe, labor union, governmental body (which would be defined in Rule 501(a)), or other legal entity with substantially similar legal attributes.

Proposals Regarding Integration under Regulation D

The integration doctrine is intended to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to the multiple offerings that would not be available for the combined offering. Rule 502(a) establishes an integration safe harbor under which offers and sales more than six months before a Regulation D offering or more than six months after the completion of a Regulation D offering will not be considered part of the same offering. The proposed amendments would shorten the safe harbor waiting period set forth in Rule 502(a) from six months to 90 days, which would allow an issuer to rely on the safe harbor once every fiscal quarter.

Guidance Regarding Integration of Public and Private Offerings

In the case of offerings for which the current six month safe harbor described above is not available, the Note to Rule 502(a) establishes a five-factor facts and circumstances test for determining whether offers and sales should be integrated for purposes of Regulation D: (a) whether the offerings are part of a single plan of financing, (b) whether the offerings involve issuance of the same class of security, (c) whether the offerings are made at or about the same time, (d) whether the same type of consideration is to be received, and (e) whether the offerings are made for the same general purpose. In response to questions and recommendations from the Advisory Committee on Smaller Public Companies, the SEC provided guidance regarding the integration of concurrent public and private offerings.

Private Placements Preceding Public Offerings

As set forth in Rule 152, in its review of Securities Act registration statements, the SEC Staff will not take the view that a completed private placement that was exempt from registration under Section 4(2) of the Securities Act should be integrated with a public offering of securities that is registered on a subsequently filed registration statement. Consistent with this approach, the SEC confirmed that, pursuant to Rule 152, a company's contemplation of filing a Securities Act registration statement for a public offering at the same time that it is conducting a private placement that was exempt from registration under Section 4(2) would not cause the Section 4(2) exemption to be unavailable for that private placement.

Private Placements Concurrent with Public Offerings

As a general matter, the filing of a registration statement has been viewed as a general solicitation of investors, particularly because information about a company and its prospects is available immediately through the EDGAR filing system upon filing. The SEC Staff has historically applied a facts and circumstances analysis to questions of potential integration of a

concurrent private offering and public offering and has issued interpretive letters under specific factual circumstances, including Black Box Incorporated (June 26, 1990) and Squadron Ellenoff, Pleasant & Lehrer (February 28, 1992), that take the position that companies may continue to conduct concurrent private placements without those offerings necessarily being integrated with the ongoing public offering notwithstanding the public availability of the information in the registration statement. Concerns remain, however, regarding an issuer's ability to complete such concurrent private placements in different factual situations.

In order to address these concerns, the SEC confirmed that, while there are many situations in which the filing of a registration statement could serve as a general solicitation or general advertising for a concurrent private offering, the filing of a registration statement does not, per se, eliminate a company's ability to conduct a concurrent private offering, whether it is commenced before or after the filing of the registration statement. Further, the determination as to whether the filing of the registration statement should be considered to be a general solicitation or general advertising that would affect the availability of the Section 4(2) exemption for such a concurrent private offering should be based on a consideration of the means of solicitation of the private placement investors, i.e. whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of the Section 4(2) exemption. This analysis should not focus exclusively on the nature of the investors, such as whether they are "qualified institutional buyers" as defined in Rule 144A or institutional accredited investors, or the number of such investors participating in the offering, but should instead focus on whether the private placement is exempt under Section 4(2) on its own, particularly whether securities were offered and sold to investors through the means of a general solicitation in the form of the registration statement.

Disqualification Provisions

In light of both the increased flexibility provided by the proposed amendments and repeated violations of the Securities Act by persons purporting to rely on the Regulation D safe harbors, the proposed amendments would apply "bad actor" disqualification provisions to all Regulation D offerings. Currently, Rule 505 is the only Regulation D exemption that provides disqualification provisions.

The proposed disqualification provisions, to be set forth in new Rule 502(e) preclude reliance by the issuer on Regulation D if any of the following persons is disqualified:

- the issuer, any predecessor of the issuer, and any affiliated issuer;
- any director, executive officer, general partner, or managing member of the issuer;
- any beneficial owner of 20% or more of any class of the issuer's equity securities; and
- any promoter connected with the issuer.

The proposed Rule 502(e) disqualification provisions would preclude an issuer from relying on Regulation D where the issuer or any of the covered persons described above:

- filed a registration statement within the last five years that is the subject of a currently effective permanent or temporary injunction or an administrative stop order;

- was convicted of a criminal offense in the last 10 years that was in connection with the offer, purchase, or sale of a security or involved making a false filing with the SEC;
- has been subject to an adjudication or determination within the last five years by a federal or state regulator that the person violated federal or state securities or commodities law or a law under which a business involving investments, insurance, banking, or finance is regulated;
- is subject to an order, judgment, or decree by a court entered within the last five years that restrains or enjoins the issuer or covered person from engaging in any conduct or practice involving securities and other similar businesses, including an order for failure to comply with Rule 503, which requires the filing of Form D;
- is subject to a cease and desist order entered within the last five years issued under federal or state securities or similar laws; or
- is subject to a suspension or expulsion from membership in or association with a member of a national securities exchange or national securities association for an act or omission constituting conduct inconsistent with just and equitable principles of trade.

Proposed Rule 502(e)(2) would expand upon current Rule 507 and allow the SEC, upon a showing of good cause, to waive any of the disqualification provisions set forth above. Proposed Rule 502(e)(2) would also provide a safe harbor for an offering by an issuer if that issuer establishes that it did not know and reasonably could not have known that the disqualification existed.

If the proposed changes are adopted, we would expect issuers relying on Regulation D to take reasonable steps to ensure compliance with these disqualification requirements, including requiring representations and warranties or disqualification questionnaires from covered persons.

Proposed Amendments to Form D

The proposed amendments would amend Regulation S-T, Rule 503, and Form D to require that Form D be filed electronically for both reporting and non-reporting issuers. In addition, the electronic filing system would allow the issuer to designate the states to which the Form D is directed and state securities regulators would be able to identify Form D filings that specify their states, which the SEC hopes would encourage state securities regulators to permit one-stop filing with the SEC and rely on SEC filings as satisfying the state law filing requirements for offerings covered by a Form D filing.

In addition, the proposed amendments would restructure Form D and implement several other technical changes. The proposed amendments would change a number of the information requirements of Form D, the most substantive of which include the following: (i) eliminate the current requirement that issuers identify owners of 10% or more of a class of their equity securities as “related persons,” (ii) require issuers to identify their revenue range for the most recently completed fiscal year, (iii) require amendments to Form D only in certain specified circumstances, (iv) require the issuer to indicate whether the offering is being made in connection with a business combination transaction such as a merger, acquisition, or exchange offer, (v) eliminate the items requiring information on use of proceeds and expenses of the offering, and (vi)

combine the federal and state signature requirements and incorporate into the signature block the consent to service of process currently in Form U-2, which is required to be filed separately but simultaneously with a Form D by many states.

Possible Revisions to Rule 504

Rule 504 of Regulation D, known as the "seed capital" exemption, is limited to offerings by non-reporting companies that do not exceed an aggregate annual amount of $1 million. Rule 504 sets forth the requirements for four separate exemptions from the registration requirements of the Securities Act. This includes Rule 504(b)(1)(iii), which provides an exemption from registration for offers and sales of securities that are conducted according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to accredited investors. Securities sold pursuant to Rule 504(b)(1)(iii) are not subject to the limitations on resale established in Rule 502(d) and, as such, are not "restricted securities" for purposes of Rule 144. Because of recent enforcement actions and concerns of state regulators relating to possible abusive practices, the SEC is soliciting comment on whether to amend Rule 504(b)(1) to provide that the limitations on resale set forth in Rule 502(d) would apply to securities sold in a Rule 504(b)(1)(iii) transaction, which would result in those securities being "restricted securities" for purposes of Rule 144.

December 2006 Release – Proposed Rules 509 and 216

In the December 2006 Release, the SEC proposed new Rules 509 and 216 under the Securities Act that would establish a new category of accredited investor, "accredited natural person," that would apply to offers and sales of securities under Rule 506 by certain private investment vehicles. The SEC has received approximately 600 comments on these proposed amendments, most of which generally disfavored the proposal, arguing that the proposal limits investor access to private investment vehicles and questioning the dollar amount of the investments standard. While the SEC is continuing to consider those comments, further comment is solicited on the proposed amendments in the December 2006 Release.

For further information, please see our memorandum titled "SEC Issues Investor Accreditation Proposals Affecting Private Funds," dated August 23, 2007.

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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