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JANUARY 7, 2010 | HANSON BRIDGETT CORPORATE PRACTICE GROUP

Proposed Changes to the Accredited Investor Rules and State Regulation of Private Investments

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The Restoring American Financial Stability Act of 2009

On November 10, 2009, Senator Christopher Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing and Urban Affairs, released the 1,136-page Restoring American Financial Stability Act of 2009 (the “Act”). The Act has attracted attention mainly for its proposed overhaul of the regulation of financial institutions and introduction of substantial changes in corporate governance and executive compensation for all US public companies. The Act is also noteworthy for its potential to significantly change the rules applicable to private investments and who has the power to regulate such investments.

For the private investment community, two proposed reforms would have a significant impact. First, Section 412 of the Act would increase the income and asset thresholds required to qualify as an “accredited investor,” thereby reducing the number of accredited investors drastically. Second, Section 928 of the Act would permit state regulation of offerings under Regulation D, which in turn is likely to increase the cost of private offerings substantially.

Adjusting the Accredited Investor Standard for Inflation

Section 412 of the Act requires that the SEC increase accredited investor annual income and net worth thresholds by “price inflation” (a term the Act does not define). Further, the Act requires the SEC to make subsequent cost of living adjustments every five years. Currently, under Rule 501 of Regulation D of the Securities Act of 1933 (17 CFR § 230.501), qualifying as an accredited investor requires at least $200,000 in annual income as an individual ($300,000 annually if filing jointly) or $1,000,000 in assets. This standard took effect when the SEC adopted Regulation D in 1982, and has not changed since.

Adjusting for inflation will increase the accredited investor standards significantly. In 2007, an SEC release noted that if adjusted for inflation as of July 1, 2006, the $1 million individual net worth test would be increased to approximately $1.9 million and the $200,000 individual income and $300,000 joint income tests would be increased to approximately $388,000 and $582,000, respectively. (Securities Act Release No. 8828 (August 3, 2007)). Adjusting for inflation as of 2010 will push up those 2007 projected amounts even more. The release further comments that the SEC's Office of Economic Analysis estimated 8.47 percent of U.S. households qualified as accredited investors at the end of 2003 (citing the Federal Reserve Board of Governors Survey of Consumer Finances, 2004). Under the Act, the percentage of qualifying households will be reduced.

If enacted, this provision will exclude a significant portion of the current private investment community from further participation in private investment opportunities. The purpose of the original accredited investor thresholds was to create a class of investors who could presumably look out for themselves or hire experts to do so, and who could in any event afford to absorb any loss realized in connection with more risky private placements. As inflation has lowered the bar, those who might not otherwise satisfy the original thresholds have found themselves "qualified" to invest. On the other hand, independent wealth is only one indicator of whether an investor is capable of protecting her or himself. Investors have found other ways to inform themselves and mitigate risk, whether through angel investment groups or independent research and analysis. Imposing an indexed standard now will only further restrain the currently cautious private investment community.

Restoring the Authority of State Regulators Over Regulation D Offerings

Section 928 of the Act repeals the federal preemption of state laws regulating accredited investor securities offerings under Regulation D of the Securities Act of 1933 (17 CFR § 230.501 et seq.). Generally, under Regulation D, a company's offering is exempt from SEC registration requirements if it meets the following conditions: (1) all sales within a certain time period that are part of the same Regulation D offering must be "integrated", meaning they must be treated as one offering, (2) information and disclosures must be provided, (3) there must be no "general solicitation", and (4) the securities being sold must contain restrictions on resale. Currently, if a company's offering meets these conditions, the company is only required to complete the relatively simple federal Form D, file it with the SEC and then file copies of the Form D with the states in which its investors reside. Though the company usually pays state filing fees, because of federal preemption, states cannot impose merit or substantive review of the offering. Streamlining the process even further, the SEC recently began requiring issuers to file the Form D electronically.

We can look to the period before Regulation D was enacted to project the possible effects of repealing federal preemption. Previously, the vast majority of states imposed their own merit review of securities offerings to residents in their states. Merit review by multiple states poses significant uncertainty for companies raising capital, and is likely to result in substantial additional costs. Without federal preemption or uniformity, states can impose varying degrees of merit review, varying length of review and comment periods, and different disclosure, notice and filings requirements, comment systems, suitability standards, and securities lending requirements. The costs associated with this process are only palatable if the amount raised is significant.

Today, Regulation D offerings make it possible for emerging growth companies, particularly web and software startups raising less than $1 million, to raise small amounts of capital in an efficient way. The ability to carry out this kind of offering makes a critical difference for the viability of the venture and aids in job creation. In the face of mandatory compliance with several sets of state laws after this provision is enacted, a company's options for low-cost financing rounds will be limited to appealing to investors residing in its home state only, or to setting ambitious minimum investment amount requirements that make multi-state offering worthwhile. Repealing federal preemption of state laws regulating offerings under Regulation

D will hinder investment and economic growth.

Take Action

Contact your senator about Section 412, Section 928 or any other section of the Restoring American Financial Stability Act of 2009.

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