K&L GATES

Securities, Investment Management, Hedge Funds and Alternative Investments Alert

August 2007 www.klgates.com

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SEC Proposes Revisions to Limited Offering Exemptions Under Regulation D

Introduction

At its open meeting on May 23, 2007, the Securities and Exchange Commission ("SEC") proposed several revisions to Regulation D under the Securities Act of 1933, as amended ("Securities Act"). The SEC issued its proposed revisions with respect to Form D on June 29, 2007. On August 3, 2007, the SEC issued proposed rules, together with requests for additional comments, with respect to the other proposed revisions.

If enacted, the revisions would:

- establish a new exemption from registration under Regulation D for "large accredited investors," which would allow for limited advertising;
- revise the definition of "accredited investor" under Regulation D to clarify it, add certain types of new investors and to encompass investors who exceed a threshold amount of investments owned;
- reduce the time period required by the integration safe harbor for Regulation D offerings to 90 days;
- provide uniform disqualification provisions for all of the exemptions under Regulation D; and
- aim to ease the burden and cost of preparing and filing a Form D with the SEC.

The SEC's stated objective for these revisions is to clarify and modernize the rules to bring them into line with modern market practice and technology without compromising investor protection.

Comments on these proposals should be received by the SEC within 60 days of their publication in the Federal Register.[1] The full text of the SEC's proposing releases (Release Nos. 33-8814 and 33-8828) (collectively "Proposing Releases") is available on the SEC website at http://www.sec.gov/rules/proposed.shtml.

Regulation D Under the Securities Act

Section 5 of the Securities Act requires any offer to sell or sale of securities to be registered with the SEC, unless such offer or sale is exempt from registration. Regulation D currently provides three exemptions (Rules 504, 505 and 506) from the registration requirements for certain limited private offerings. Companies that rely on an exemption under Regulation D are required to file a Form D with the SEC within 15 days following the initial sale pursuant to the exempt offering.

[1] Comments to the SEC's proposed revisions to Form D are due by September 7, 2007.

Proposed New Rules Under the Securities Act

New Limited Offering Exemption Under Regulation D

The SEC proposes to create a new safe-harbor exemption ("Rule 507 Exemption") from the registration requirements of the Securities Act for offers and sales of securities to a new category of investors known as "large accredited investors." Issuers relying on the Rule 507 Exemption would be permitted to make use of limited advertising. However, pooled 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 of 1940, as amended, would be precluded from selling their securities in reliance on the Rule 507 safe harbor.

Just as Rule 506 requires only that purchasers and not offerees be accredited, so Rule 507 would require that only purchasers need qualify as "large accredited investors," not offerees. Securities sold pursuant to the Rule 507 Exemption would be treated as "restricted securities," and the issuer would need to exercise reasonable care to ensure that the purchasers of the securities are not underwriters. As with Rule 506, the issuer would not be restricted from paying commissions or other transaction-related compensation in connection with sales.

For purposes of the Rule 507 Exemption, the definition of "large accredited investors" would generally consist of the same categories of entities and natural persons that qualify for accredited investor status under Regulation D, subject to higher monetary thresholds. The definition of "large accredited investor" would include any natural person who has in excess of $2.5 million in investments or has an annual individual income in excess of $400,000 or joint annual income with that individual's spouse in excess of $600,000. Legal entities that are considered "accredited investors" if their total assets exceed $5 million would qualify as "large accredited investors" if they have in excess of $10 million in investments. In addition, legal entities that are not subject to dollar-amount thresholds to qualify as "accredited investors" (*i.e.*, banks, registered investment companies, private business development companies and other regulated entities identified in Rules 501(a)(1) and (2) of Regulation D) as well as directors and executive officers of the issuers would not be subject to dollar-amount thresholds to qualify as large accredited investors. The proposal includes an inflation adjustment to the investment and income standards described above that would first be triggered in 2012.

Unlike issuers relying upon other exemptions under Regulation D that would be limited to the type of notice set forth in Rule 135c, issuers that rely on the new Rule 507 Exemption for an offering would be permitted to publish a limited announcement of the offering. At the issuer's option, the announcement would be permitted to contain the following information:

- The name and address of the issuer;
- A brief description of the business of the issuer in 25 or fewer words;
- The name, type, number, price, and aggregate amount of securities being offered and a brief description of the securities;
- A description of what large accredited investor means;
- Any suitability standards and minimum investment requirements for prospective purchasers in the offering; and
- The name, postal or e-mail address, and telephone number of a person to contact for additional information.

The announcement would also be required to state prominently that sales will be made to "large accredited investors" only, that no money or other consideration is being solicited or will be accepted through the announcement, and that the securities have not been registered with or approved by the SEC and are being offered and sold pursuant to an exemption. Only advertising in written form would be permitted; radio and television broadcast advertisements (*e.g.*, infomercials) would be prohibited.

An issuer relying on the Rule 507 Exemption would not be allowed to sell securities to any investor who was not a "large accredited investor." This is in contrast to Rule 506, under which an issuer may sell securities to up to 35 non-accredited investors in addition to an unlimited number of "accredited investors." In addition, because limited advertising would be permitted, an issuer could only conduct a Rule 507 offering at the same time as

a Rule 506 offering if the two offerings are considered separate and distinct under the five-factor integration test set out in Rule 502(a) of Regulation D.

The SEC also proposes that a "large accredited investor" that participates in a Rule 507 offering be defined as a "qualified purchaser" under the Securities Act. As such, securities sold in a Rule 507 offering would be "covered securities," and thus state securities regulation would be preempted.

Revisions to the Definition of "Accredited Investor" Under the Securities Act

The SEC proposes to add alternative standards for entities and for individuals and spouses. The proposal provides for "investments owned" by the prospective investor as an additional method of establishing "accredited investor" status. Along with the current net worth and income standards for a natural person specified in Rule 215 or Rule 501(a) under the Securities Act,[2] as applicable, the revised definition of accredited investor would extend accredited investor status to any natural person who has in excess of $750,000 in investments and any institution that has in excess of $5,000,000 in investments. The value of personal residences and places of business would not be included in determining whether an investor meets the threshold under the investments-owned standard (although such values would continue to be included in the calculation of net worth).

Designed to reduce uncertainty and legal costs and to promote efficient private capital formation, the revised definition of accredited investor would also include additional types of legal entities that may qualify as accredited investors. Under the proposal, limited liability companies, Indian tribes, labor unions, governmental bodies (including nations, states, counties, towns, villages, districts and other jurisdictions, domestic and foreign) and other legal entities with substantially similar attributes would be accredited investors if they have total assets or investments in excess of $5,000,000. The SEC staff has also requested comment on whether the definition of "qualified institutional buyer" in Rule 144A should be similarly expanded.

This proposal also includes inflation adjustments to the net worth, income, assets and investment standards that would first be triggered in 2012, and clarifies how investments jointly owned with a person's spouse may be included in meeting the "investments" standard.

In the Proposing Releases, the SEC stated that its "experience indicates that some issuers have not taken appropriate measures to satisfy their obligation under Rule 501(a) to form a reasonable belief that a prospective purchaser satisfied the definition of accredited investor." Accordingly, the SEC also requested comment on whether a safe harbor should be added to Regulation D that would set forth the type of investigation that an issuer must conduct to reach a reasonable belief that an investor is an "accredited investor."

Private Pooled Investment Vehicle Release

In 2006, the SEC also proposed to change the standards for natural person accredited investors in private pooled investment vehicles in its Release No. 33-8876 (Dec. 27, 2006) [72 Fed. Reg. 399]. In the Proposing Releases, the SEC indicated that they have received approximately 600 comments on the private pooled investment vehicle proposal (many of which generally disfavored it), are continuing to consider those comments and are requesting additional comments on this proposal. The SEC indicated that they may act on both proposals at the same time.

Reduction of the Time Frame for the Integration Safe Harbor in Regulation D

The SEC proposes to reduce the time frame for the integration safe harbor in Rule 502(a) of Regulation D under the Securities Act from six months to 90 days. The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering for which no exemption is available into multiple offerings so that an issuer could

[2] Rule 501(a) of Regulation D under the Securities Act and Rule 215 under the Securities Act define an "accredited investor," in part, as any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds $1,000,000 or any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

take advantage of an exemption under Regulation D. Under the current safe harbor, 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. By abbreviating the time frame required to make use of the safe harbor to 90 days, the proposal is designed to ease restrictions on an issuer's ability to engage in a series of exempt offerings over a limited period of time, thereby increasing flexibility to issuers in their efforts to raise capital.

Introduction of "Bad Actor" Disqualifications for All Offerings Under Regulation D

The disqualification provisions in proposed new Rule 502(e) would preclude an issuer from reliance on any of the exemptions under Regulation D if the issuer or if certain persons connected with the issuer have been shown to have acted improperly. As proposed, each of the provisions would require a determination by a government official or agency or self-regulatory organization that the relevant person has violated the law or engaged in other wrongdoing. The period of disqualification would generally last five years, except for certain criminal convictions.

Currently, only offerings relying on the exemption from registration under Rule 505 are subject to disqualification provisions.[3] This proposal would apply to all offerings under Regulation D.

Revisions to Form D; Electronic Filing of Form D

In an effort to simplify Form D, ease the costs and burdens associated with preparing and filing a Form D, and modernize the "information capture process," the SEC proposes to modify Form D and mandate the electronic filing of Form D with the SEC in connection with limited offerings made pursuant to Regulation D. The electronic filing of Form D would be exempt from the prohibition under Rule 502(c) of Regulation D on the use of general solicitation and general advertising, provided that the filing is made in good faith and the issuer makes reasonable efforts to comply with the requirements of Form D.[4] The electronic Form D would not permit "free writing" (*i.e.*, an issuer could only submit the information permitted under the Form D template).

The SEC believes these proposals, if adopted, would streamline the Form D filing process and make it easier for issuers to comply with the filing requirements of Rule 503 of Regulation D. Furthermore, information filed with the SEC pursuant to the electronic Form D would be more readily available to the general public.

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[3] Rule 505(b)(2)(iii) of Regulation D disqualifies issuers identified in Rule 262 of Regulation A under the Securities Act from relying on the Rule 505 exemption. Rule 262 of Regulation A establishes criteria that may disqualify an issuer from relying on the exemption provided by Regulation A.

[4] Form D contains basic information about the issuer, the offering, and the exemption claimed.