The Dodd-Frank Reform Act Makes Raising Private Equity More Difficult For Entrepreneurs

By Clem Turner

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) passed both houses of Congress and was signed into law on July 21, 2010. Unfortunately, one of the provisions of this recently enacted bill will make it harder for start-up and developing companies to raise funds from their friends and family.

Background: The Private Equity Fund Raising Process

Early stage companies typically secure capital from private investors through equity offerings commonly referred to as "Private Placements." Capital is being "placed" into these companies privately, not in a public offering. You may have heard the term "IPO," which stands for initial public offering. IPO's and subsequent public offerings require a lengthy, complicated and expensive process. Moreover, investors in a public offering must receive a document (called a prospectus) that discloses a significant amount of specific and detailed company information, including audited financial statements. Investors in a private placement do not need to receive a prospectus and private placements can be completed in a shorter timeframe with less complexity and expense. The rules that pertain to various private placements are codified in Rule 501 through Rule 506 of the Securities Act of 1933, also known as Regulation D.

Under Regulation D, as long as the Company has not engaged in a general solicitation of its securities to the public, it can sell securities privately to certain targeted investors. Furthermore, the procedure for a private placement is much simpler if you only sell to investors who meet the definition of an "accredited investor." In summary, the relevant portions of the definition of an accredited investor are: (i) a company or financial institution with over $5,000,000 in assets, (ii) any director, executive officer, or general partner of the company issuing the securities or (iii) an individual with either a net worth of $1,000,000 or an annual income of $200,000 alone or $300,000 together with his or her spouse.

The Effect of the Dodd-Frank Act

Prior to the Act, individuals were able to incorporate the value of their home into the calculation of their net worth. In states with expensive home values, such as New York and California, this enabled quite a few individuals to qualify as accredited who might not meet the annual income criteria. For the entrepreneur seeking to raise funding for his or her company or project, there was a higher likelihood that friends and family members in New York or California would meet the $1 million net worth threshold because of high real estate values.

One of the terms of the Dodd-Frank Act expressly excludes the value of an investor's primary residence when calculating his or her net worth, for purposes of determining if the investor is accredited. As a result, the pool of accredited investors has shrunk, and the probability that a friend or family member of an entrepreneur will meet the accredited investor criteria is significantly diminished. Furthermore, last week on July 27, 2010, the Securities and Exchange Commission released a "Compliance and Disclosure Interpretation" based on the Dodd-Frank Act. They clarified that while the value of a home is to be excluded from an investor's assets, the value of its mortgage may likewise be excluded from an investor's liabilities, unless the home's value is "underwater," meaning the value of the home is less than the current mortgage. If this is the case, the amount the mortgage exceeds the home's value should be considered a liability and deducted from the investor's net worth.

Private Placements with Non-Accredited Investors

Regulation D allows for several private placement exceptions, based on the amount of money being raised. If your company is raising less than $1 million in any 12 month period, you are allowed to sell to accredited or non-accredited investors; however you will need to provide, among other things, a disclosure document to your investors that contains no material misstatements and no material omissions. This disclosure document does not have to meet the requirements of a prospectus.

However, if your company is raising over $1 million, only 35 non-accredited individuals can participate. Furthermore, the disclosure required when you sell equity to non-accredited investors is onerous. Your accredited investors only need to receive a disclosure document that contains no material misstatements and no material omissions. Your non-accredited investors will have to receive a document that generally meets the requirements of a prospectus, including audited financial statements. This adds considerable complexity, time and expense to a company's private placement.

Finally, if your company is raising over $5 million, all non-accredited investors participating in your offering, either alone or with a purchaser representative, must be "sophisticated." This means, they must have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of a prospective investment in your company. Your friends and family, who cannot meet the accredited investor net worth threshold, may not be able to satisfy the test to be a sophisticated investor. Therefore, you would have to incur the additional expense of hiring a purchaser representative to advise them in order for them to make an investment in your company.

Lastly, in addition to the federal rules, many states place additional burdens on your company if you raise money by selling equity or debt to non-accredited residents of their state. These states may require additional filings and fees.

Conclusion

The Dodd Frank Act has decreased the likelihood that your friends and family can participate in your offering as accredited investors. While they may still be able to purchase shares in your company's private offering, the additional expense that results may be greater than the amount

they can afford to invest. If you are contemplating an equity raise, you should address the accredited investor thresholds with your friends and family early on, so you can intelligently manage this issue. Also remember, if you are considering a follow-up offering, investors who met the accredited investor threshold before the passage of the Dodd Frank Act, may no longer satisfy it now. It is a good idea to consult a securities lawyer during the initial stages of your equity raising process.

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