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Dodd-Frank Reform Bill May Put a Damper on Private Placements

Two little-noted provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), enacted on July 21, have the potential to make less attractive a "safe harbor" exemption for private placements of securities currently available under the Securities Act of 1933, as amended (the '33 Act).

Rule 506 of Regulation D, promulgated under the '33 Act, has provided, subject to other provisions of Regulation D, a "safe harbor" for the sale of securities to an unlimited number of "accredited investors" as well as to no more than 35 sophisticated investors who are not "accredited investors." The Dodd-Frank Act provides for the narrowing of the definition of "accredited investor" and adds "bad boy" provisions to Rule 506 of Regulation D.

Currently, an "accredited investor," as defined in Rule 501 of Regulation D, includes natural persons whose individual net worth or joint net worth with a person's spouse exceeds $1 million at the time of his purchase of securities or 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. That definition has been unchanged since 1982. Section 413 of the Dodd-Frank Act excludes the value of a person's primary residence from the Rule 501 formulation and requires the Securities and Exchange Commission to review the entire accredited investor definition to determine whether any adjustments are appropriate "for the protection of investors, in the public interest and in light of the economy," except that until July 21, 2014 (four years after enactment) the $1,000,000 net worth test and the primary residence exclusion may not be changed. After July 21, 2014 and at least once every four years thereafter, the SEC is directed to review the definition in its entirety, including the income and worth levels in the Rule 501 test.

While it is not clear from a reading of Section 413 when the primary residence exclusion is effective—immediately upon enactment on July 21 or following SEC rulemaking, the SEC Staff has provided oral guidance to the effect that the exclusion became effective on enactment on July 21.

Separately, in Section 926 of the Dodd-Frank Act, the SEC is required, within one year of enactment, to adopt amendments to Rule 506 that are "substantially similar" to the provisions of Rule 262 of Regulation A, covering limited offerings by companies. Such rules would disqualify offerings by companies (and, presumably, individuals associated with companies) subject to "bad boy" orders barring them from financial or securities activities or association with certain regulated entities, who are subject to a final order based on fraud violations within the past 10 years, or who have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or involving the making of false filings with the SEC. The precise scope of the disqualifications and the extent to which they will apply to officers, other employees, directors or control persons who are or were "bad actors" so as to disqualify an issuer from conducting a Rule 506 offering will have to await SEC rulemaking.

These provisions will likely limit the population of "accredited investors" eligible under Rule 506 of Regulation D and, more consequentially, for the first time upon SEC implementation, will limit the availability of Rule 506 itself for companies who are, or whose specified personnel are, or in the past have been, "bad boys."

Click here to read the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

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