

CLIENT ADVISORY:

RECOMMENDED CHANGES TO ACCREDITED INVESTOR QUALIFICATIONS COULD COMPLICATE RAISING CAPITAL FROM OUTSIDE INVESTORS

Executive Summary

The information set forth below is important to any company or private equity fund that is considering raising capital from outside investors. Although it is somewhat technical, the practical implications are clear. If the SEC adopts even some of the changes in the definition of “accredited investors” summarized below, the pool of accredited investors would almost certainly be reduced. While this reduction in the number of accredited investors would not preclude private companies and investment funds from relying upon the traditional exemptions under the securities laws (Rule 506, etc.), it would likely require enhanced informational disclosure to investors (because not all offerees would continue to qualify as accredited), with the resulting increase in legal fees incurred in connection with private placements of securities. Companies and investment fund sponsors who are considering private placements of securities this year may be well served by commencing their fund raising sooner rather than later, due to the strong possibility the rules will change.

Background

Companies and investment funds seeking to raise capital from outside investors need to be sure that their fund raising activities are in full compliance with federal and state securities laws. In general terms, an offering of securities must be registered with the Securities Exchange Commission unless an exemption from the registration requirements is available. “Registration” refers to the expensive and time consuming process typical of an initial public offering or “IPO.” Registration is simply not a practical alternative for smaller businesses and investment funds. However, so-called “Regulation D” offers some of the most popular and commonly used private placement exemptions.

For purposes of qualifying for these exemptions, Regulation D typically divides investors into two



categories: accredited investors and non-accredited investors. Basically, the SEC views non-accredited investors as those who are more in need of the full level of protection afforded by the securities laws, while accredited investors are viewed as needing far less protection. For example, Rule 506 (perhaps the most commonly used exemption) permits a private company or fund seeking investment capital to offer their securities in a private placement to an unlimited number of accredited investors and does not mandate any particular type of information to be disclosed in order to qualify for the Rule 506 exemption. Conversely, if an offer is made to even a single non-accredited investor, Rule 506 requires that all potential investors be provided with a great deal of information regarding the company or fund, the nature of the securities, information regarding the principals and management team, risk factors, etc. It also requires that this information be presented in a standardized format mandated by the SEC. As a result, the legal fees related to preparing the more extensive private placement documents are substantially greater if non-accredited investors are included in the proposed private placement.

Recommendations of the SEC Investor Advisory Committee

In the fourth quarter of 2014, the SEC’s Investor Advisory Committee (the “Committee”) made recommendations to the SEC regarding the qualifications for accredited investors and related matters.

Under current law, a person qualifies as an accredited investor if he or she meets certain income or net worth tests (income in excess of \$200,000 (\$300,000 jointly if married) in each of the last two years and a reasonable expectation of that level of income for the currently year or a net worth in excess of \$1 million (excluding the value of the investor's primary residence). While the Committee did not expressly recommend revising these financial thresholds, it did recommend careful evaluation of whether the current definition effectively identifies individuals who do not need the protections afforded under the Securities Act of 1933. It went on to say that if, as the Committee expects, the current standards include a significant percentage of individuals who are not capable of protecting their own interests, the SEC should promptly move to revise the current definition. This recommendation is particularly telling when one considers the fact that the current financial thresholds, had they been adjusted for inflation since they were originally adopted, would have increased to roughly \$500,000 of income or approximately \$2.5 million in net worth.

The Committee also recommended that if the SEC continues to rely upon a definition driven by financial thresholds, it should consider adding additional criteria, including limiting the percentage of a person's assets or income that could be invested. Additional recommendations included encouraging development of alternative means for verifying accredited investor status; tightening requirements for qualification of persons acting as purchaser representatives for investors and revising the definition of accredited investors to include individuals who have a high level of financial sophistication even though they may not meet financial thresholds.

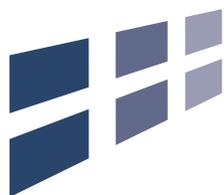
We will issue another Client Advisory summarizing further developments as more information becomes available. If you have any questions, please contact your regular PLDW attorney or William F. Miller at wmiller@pldw.com.



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William F. Miller is a Partner with Pannone Lopes Devereaux & West LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.

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