# "Accredited Investor" Definition Change Creates Challenges for Capital Raising

It now may be harder than ever for small-business owners to raise capital, not only due to tight credit markets, but also because it will now be more difficult to find qualified "accredited investors" who could finance the business with a private-securities offering.

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VIEWPOINT

When President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010, the definition of an "accredited investor" changed.

While the new law continues to define an "accredited investor" as an individual having a net worth of at least $1 million, it now excludes the value of an investor's primary residence from the net-worth calculation.

Because an investor's primary residence is in many cases his or her largest asset, many would-be private-placement investors will no longer qualify as "accredited investors."

According to Rule 506 of Regulation D of the Securities Act of 1933, business owners can raise capital with a private-securities offering by selling a piece of their business to passive investors.

Rule 506 allows business owners to raise an unlimited amount of money in a 12-month period from any number of high-net-worth or "accredited investors," plus up to 35 non-accredited investors who nevertheless are considered to be "sophisticated investors," though most Rule 506 private-placement offerings are made exclusively to accredited investors.

Now with fewer accredited investors to choose from, it may be harder to find the capital small businesses need to get off the ground, particularly if they can't obtain a traditional bank loan.

## Existing private placements

Small-business owners that have already financed their business through a private securities offering before July 21, 2010, do not need to make any changes, as the Dodd-Frank law has no retroactive application.

Unfortunately, due to the challenging economy, obtaining business loans from banks is harder than ever. According to CNNMoney.com, U.S. banks decreased their business-loan balances by approximately $1 billion in 2009, and while banking loans have increased in 2010, economic fears remain.

## Background on private placements

While it may be more challenging now to find "accredited investors," financing a business with a private placement may still be the best way to raise capital.

There are certain fundamental legal requirements you must follow to raise any amount of capital from investors.

In the years following the market and economic crash of 1929, the federal government created the Securities and Exchange Commission (SEC) and delegated power to it under the Securities Act of 1933. The Securities Act requires registration with the SEC of all securities offerings, whether you are selling debt (a promise to repay) or equity (shares of stock in a corporation or an ownership interest in a limited-liability company).

Over time, certain exemptions and safe harbors were carved out of the 1933 Act to permit companies to avoid the cost and complexities of a public-securities offering.

Chief among the safe harbors from SEC registration is Regulation D of the 1933 Act. Regulation D is a series of six rules, Rules 501-506, establishing three transactional exemptions (Rules 504, 505 and 506) from the registration requirements of the 1933 Act.

Since the National Securities Markets Improvement Act of 1996, the overwhelming majority of small businesses and other issuers have relied on Rule 506 because it permits companies to raise an unlimited amount of money from investors. And except for certain state form and filing fees, Rule 506 (unlike 504 and 505) preempts any state securities laws or regulations that would otherwise require registration of the securities on the state level.

Rule 506 is at its core a disclosure regulation. Issuers generally are required to disclose a variety of information to investors in the form of a private-placement memorandum relevant to the nature, characteristics, and inherent risks of the investment. The rule requires disclosure of anything material that a reasonable investor would want to know in deciding whether to invest.

Compliance is essential. As mentioned earlier, an unlimited amount of money can be raised in a 12-month period from any number of "accredited investors," plus up to 35 non-accredited investors.

A private offering must be just that, private. The issuer in fact is required to have a pre-existing relationship with the potential

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investor. Cold calling, seminars, or other general solicitations published in the newspaper or on the Internet are prohibited.

In addition, any sale of securities (public or private) is also governed by Rule 10b-5 of the 1934 Securities Exchange Act, an anti-fraud statute, which imposes liability on the issuer for any material misstatements or omissions to investors.

It's a statistical fact that many start-ups and small businesses will fail. If the unsuccessful business was financed by investors by means of a legally compliant, private-securities offering, those investors accept the risk of losing their entire investment.

Any significant deviation from the rules, however, may result in the loss of the exemption from registration. In that case, beyond other enforcement remedies available to the SEC, the issuer would likely have to offer to rescind the sale of the securities and return each investor's money. ❑

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