

Dodd-Frank Act Includes Immediate Change to “Accredited Investor” Definition for Natural Persons

Financial Services Reform Alert from K&L Gates

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On July 21, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Among the many provisions of the Dodd-Frank Act is a change to the definition of "accredited investor" under the Securities Act of 1933, which takes effect immediately and may impact issuers currently engaged in private offerings.

Revisions to Accredited Investor Definition

Issuers raising capital in private offerings often rely on the accredited investor definition in determining whether the offering is exempt from the registration requirements of the Securities Act. The definition of accredited investor contained in Rule 215 and Regulation D currently includes, among other categories, 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 his or her 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; or
- whose individual net worth, or joint net worth with his or her spouse, at the time of his purchase exceeds \$1 million (such calculation includes the value of an investor's primary residence).

The Dodd-Frank Act revises the accredited investor definition as it relates to natural persons to exclude the value of a person's primary residence from the \$1 million net worth test. This change will effectively increase the net worth requirement for many investors that are natural persons. The other provisions of the accredited investor definition, including the net income test for natural persons, remain unchanged at this time.

It is anticipated that the Staff of the Securities and Exchange Commission (SEC), in applying the \$1 million net worth test, will allow investors to exclude any mortgage or any other debt secured by the investor's primary residence that does not exceed the fair market value of the residence. If, however, the amount of such debt exceeds the fair market value of the residence and the lender has recourse to the investor personally for any deficiency, investors would be required to deduct the excess liability from the net worth calculation.

Changes Immediate

The revision to the accredited investor definition as it applies to natural persons is effective immediately, with no transition period or grandfathering for private offerings that are already in progress but have not yet been completed.

With the passage of the Dodd-Frank Act, private funds and other issuers relying on the accredited investor definition in connection with ongoing private offerings that may involve investors who are natural persons should **revise disclosure and subscription documents now to reflect this modification of the net worth test.** To the extent subscription materials have already been received from investors who are natural persons, private funds and other issuers should consider whether new accredited investor representations are required to ensure the availability of an exemption from the registration requirements of the Securities Act.

Additional Changes May Be Coming

The Dodd-Frank Act also lays the following groundwork for potential future changes to the accredited investor standards:

- The SEC is authorized to review the definition of accredited investors as it applies to natural persons and make adjustments, by notice and comment rulemaking, as it deems appropriate for the protection of investors, in the public interest, and in light of the economy. However, the SEC cannot, during the first four years after enactment, modify the net worth standard.

- After four years from the date of enactment, and not less than once every four years thereafter, the SEC must review the accredited investor definition as it applies to natural persons, including both the net worth and income tests, and may make such adjustments, by notice and comment rulemaking, as it deems appropriate for the protection of investors, in the public interest, and in light of the economy.
- The U.S. Comptroller General is required to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds, and must submit a report on the results of such study to Senate and House committees, within three years after the enactment of the Dodd-Frank Act.