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DODD-FRANK ACT EXCLUDES PRIMARY RESIDENCE FROM ACCREDITED INVESTOR NET WORTH STANDARD

Upon President Obama's signing of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the definition of "accredited investor" under Rule 215 of the Securities Act of 1933 was changed to exclude a natural person's primary residence from the net worth standard. "Accredited investor" is a key definition under the Securities Act of 1933 (the "Securities Act") in determining who may participate in private offerings. Rule 505 of Regulation D permits issuers to raise capital of up to $5 million from an unlimited number of "accredited investors" and up to 35 additional investors. Rule 506 permits investors to raise an unlimited amount of capital from an unlimited number of "accredited investors" and up to 35 additional sophisticated investors. Any sales to non-accredited investors under the rules require significantly enhanced disclosure.

Definition of "Accredited Investors"

Rule 215 and Regulation D currently define "accredited investor" to include, 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 or her purchase exceeds $1 million.

The change in the definition which excludes a natural person's primary residence from the net worth test is now effective. It increases significantly the net worth requirement for many investors that are natural persons whose main asset is the value in their homes. Accordingly, many individuals who relied on the value in their homes to meet the accredited investor standard will no longer fall within the definition. It applies to offerings that are already in progress, even those that have had initial closings. The other provisions of the accredited investor definition, including the net income test for natural persons, remain the same, but, as described below, the SEC will be considering whether they need to be changed.

In addition, the staff of the Securities and Exchange Commission ("SEC") has issued an interpretation that the amount of any mortgage or other indebtedness secured by an investor's primary residence should be netted against the value of the residence, as long as the amount of the indebtedness is less than the fair market value of the residence for the purpose of determining whether the investor meets the new standard. 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.

Effect of Changes

Issuers, including private investment funds, who rely on the accredited investor definition in connection with ongoing private offerings that may involve investors who are natural persons, need to revise disclosure and subscription documents immediately to reflect this change in the net worth test. To the extent subscription materials have already been received from investors who are natural persons relying on the net worth test, issuers should obtain new accredited investor representations to ensure the availability of the Regulation D exemption from the registration requirements of the Securities Act. If certain investors in an issuer will no longer satisfy the accredited investor standard, perhaps most importantly, the issuer will need to provide enhanced disclosure to these investors to comply with the Regulation D safe harbor.

Future Changes to Accredited Investor Standards

The Dodd-Frank Act also provides for other possible 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 enactment.

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