

## Securities Attorneys

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**DODD-FRANK ACT MAKES IMMEDIATE CHANGES TO ACCREDITED INVESTOR STANDARD IN PRIVATE PLACEMENTS**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) was signed into law on July 21, 2010. The Act modifies the net worth standard for an "accredited investor," authorizes the SEC to review and adjust "accredited investor" standards as they apply to individuals and prohibits the offer or sale of securities under Regulation D by certain "bad actors."

**Immediate Change to Net Worth Standard for Accredited Investors**

Effective July 21, 2010, the date of enactment of the Act, Section 413(a) of the Act changed the net worth standard for an individual accredited investor to exclude the value of the individual's primary residence. The net worth threshold for an accredited investor remains \$1 million, either individually or jointly with a spouse; however, individuals are no longer permitted to include the value of their primary residence for purposes of reaching the \$1 million net worth standard. The SEC recently provided guidance, in a July 23, 2010 Compliance and Disclosure Interpretation, that the amount of any indebtedness that is secured by a primary residence up to the value of the residence should also be excluded in determining net worth, but any such indebtedness in excess of the value of the residence should be considered a liability and deducted from an individual's net worth.

This change affects the definition of an accredited investor for Regulation D offerings.<sup>1</sup> Rule 505 of Regulation D permits sales to be made to an unlimited number of accredited investors and up to 35 non-accredited investors as long as the size of the offering does not exceed \$5 million. Rule 506 of Regulation D permits sales to be made to an unlimited number of accredited investors and up to 35 financially sophisticated non-accredited investors without any limit on the size of the offering. In either case, substantial disclosure must be provided to non-accredited investors.

The \$1 million standard (excluding a primary residence) remains fixed for four years following the Act's passage. After the initial four-year period, the SEC may further adjust the accredited investor net worth standard.

Given that the change was immediately effective on July 21, 2010, any issuer conducting a private placement under Regulation D or Section 4(6) should revise its subscription documents to incorporate the new net worth standard.

**Subsequent Review and Adjustment by the SEC**

*Discretionary Review and Adjustment of Accredited Investor Standards.* The Act authorizes, but does not require, the SEC to review its accredited investor standards, as applicable to individuals, to determine whether the standards should be adjusted for the protection of investors, in the public interest or in light of the economy. Currently, an individual is an

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<sup>1</sup>The change to the accredited investor standard will also apply to the exemption in Section 4(6) of the Securities Act of 1933 for offers or sales solely to one or more accredited investors if the offering does not exceed \$5 million. Because the Section 4(6) exemption requires the issuer to establish that all offerees are accredited investors, while Regulation D only requires that purchasers be accredited, Regulation D is generally more useful than Section 4(6).

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accredited investor if he or she had an income above \$200,000 individually or \$300,000 jointly with a spouse in each of the two previous years, as well as a reasonable expectation of maintaining those income levels, or a net worth (individually or jointly with a spouse) of at least \$1 million. The Act authorizes the SEC to adjust these income and net worth standards for individuals, except that the \$1 million net worth standard (excluding the value of a primary residence) may not be adjusted until four years after the date of enactment. This change applies to the accredited investor standard as applicable to both Section 4(6) and Regulation D offerings.<sup>2</sup>

*Adjustments for Inflation.* Although the Act does not specifically address this point, any review by the SEC of the accredited investor standards for individuals may consider that the income and net worth have not previously been adjusted to account for inflation. The \$1 million net worth and \$200,000/\$300,000 income standards were established in 1982. If the accredited investor income standards were fully adjusted for inflation, the required annual income currently would be approximately \$449,000 individually and \$674,000 jointly with a spouse, and the net worth standard would be approximately \$2.25 million. Such an adjustment would, of course, significantly reduce the number of persons who qualify as accredited investors. At this point it is unclear whether the SEC will adjust for inflation, and, even if it does, whether it would set standards to account for the full effect of inflation since 1982.

### **Prohibition on Offering or Sale of Securities by Certain "Bad Actors"**

The Act requires the SEC, not later than one year after the Act's passage, to issue rules disqualifying any offer and sale of securities under Regulation D by certain "bad actors." The new rules disqualifying such "bad actors" from Regulation D exempt offerings must be substantially similar to the disqualifying provisions of Rule 262, and must disqualify any offering of securities by a person that (1) is subject to a final order barring the person from engaging in the business of securities, insurance or banking; (2) is subject to a final order that is based on a violation of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct within the ten years prior to the new offering; or (3) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving false filings with the SEC. Rule 262's disqualification provisions cover directors and officers of an issuer and beneficial owners of 10% or more of any class of equity securities of an issuer.

### **SEC Review of Regulation D Offerings Not Required**

The Act as signed into law does not include a provision, contained in an earlier version of the bill, that would have required the SEC to review Regulation D offerings. A prior version of the bill would have mandated SEC review of Regulation D offerings and given the SEC 120 days to complete its review. If the SEC did not complete its review within 120 days, the securities being issued would lose their exempt status and would become subject to state securities laws. The final Act does not contain the proposed Regulation D review requirements.

If you have any questions or concerns regarding the issues discussed in this e-alert, please contact your Reinhart attorney or an attorney with Reinhart's securities team.

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<sup>2</sup> The Act separately requires the SEC to review the accredited investor standard for purposes of the Section 4(6) exemption.