



New Higher Standard for Accredited Investors in Private Offerings

By David Hoepfner, Esq.

Amendment to Accredited Investor Standard

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) approved by Congress last year significantly narrowed the definition of “accredited investor,” a standard for investors to participate in certain private offerings of securities. Prior to the enactment of the Act, an individual accredited investor could include the value of his/her primary residence in \$1,000,000 net worth requirement for accredited investors. After passage, the value of one’s primary residence is no longer included in the calculation of net worth. Accordingly, many individuals who relied on the value in their homes to meet the accredited investor standard will no longer fall within the definition. This exclusion will negatively impact the ability of small companies to raise capital by reducing the pool of qualified investors.

Background

Under the rules of the Securities Act of 1933, individuals and entities that qualify as “accredited investors” are eligible to participate in certain private and limited offerings that are exempt from Securities Act registration requirements. An exemption exists for the sale of securities to “accredited investors,” which the SEC explains is “a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase” or “a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.”ⁱ

Additionally, the Act provides an exemption from registration and disclosure requirements for a maximum of \$5 million of securities offered or sold solely to accredited investors (with no advertising or public solicitation) and, under the safe harbor exemptions, securities may be sold to an unlimited number of accredited investors but not more than 35 non-accredited investors.

The New Proposal

After passage by Congress, the Securities and Exchange Commission (“SEC”) proposed rules on January 25, 2011 to clarify the meaning of the changes, including how primary residences which are “underwater” are treated. The SEC’s interpretation of Section 413(a) of the Dodd Frank Act calculates the “value of the primary residence” by subtracting the amount of debt secured by the property, from the estimated fair market value of the property. If the primary residence is underwater, any excess of the mortgage over the fair market value of the property is treated as a liability and subtracted from the investor’s other assets.ⁱⁱ

The SEC considered but declined to define the term “primary residence” in order to avoid unnecessary complexity, believing that issuers and investors should be able to rely on the common understanding of the term as the home where a person resides most of the time.

The new net worth standard will remain in effect until July 21, 2014. Beginning in 2014, the Commission is required to review the definition of the term “accredited investor” in its entirety every four years and engage in further rulemaking to the extent it deems appropriate.

Action Items

Companies and private funds raising capital should pay special attention to these recent changes. Those seeking to raise capital through private offerings will need to revise their disclosure and investment documents to ensure that they address the change in the accredited investor definition. The SEC is seeking comments on whether the final rule should allow an investor who previously qualified as an accredited investor before enactment of 413(a) to retain the status for purposes of “follow-on” investments with the same company. Nevertheless, issuers should re-examine past investors to ensure that such investors will be eligible to participate in future capital raises as accredited ⁱⁱⁱinvestors.



Clients who have any further questions or concerns about the information contained in this Advisory should not hesitate to contact us.

ⁱ SEC Regulation D, Rule 501(a):

<http://taft.law.uc.edu/CCL/33ActRIs/rule501.html>

ⁱⁱ The SEC’s proposed rule with explanation may be found here: <http://www.sec.gov/rules/proposed/2011/33-9177.pdf>

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