Dodd-Frank Act Excludes Value of Residence From Accredited Investor Net Worth Test

by Gabriella A. Lombardi and William T. Krause

The U.S. Senate voted today to approve the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which President Obama is expected to sign into law as early as next week. Upon enactment, the Dodd-Frank Act immediately alters the definition of accredited investor under Regulation D of the Securities Act of 1933 (Securities Act), which will reduce the pool of individuals qualified to invest in private offerings and immediately affect issuers currently engaged in private placements.

Rules 505 and 506 of Regulation D under the Securities Act are two of several rules that allow issuers to raise capital while remaining exempt from the registration requirements of the Securities Act. Rule 505 permits issuers to raise up to $5 million in any 12-month period from an unlimited number of accredited investors, as well as up to 35 additional investors. Similarly, Rule 506 allows issuers to raise unlimited capital from an unlimited number of accredited investors, as well as up to 35 additional sophisticated investors. As a result, the availability of the exemption often depends upon whether an individual is an accredited investor. Under Rule 501(a), the definition of accredited investor includes, among other categories, any natural person:

- whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase, exceeds $1,000,000, or

- who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the next year.

Currently, the net value of an investor's primary residence may be included in determining the investor's net worth.

Immediately upon enactment, Title IV of the Dodd-Frank Act will exclude the net value of the investor's primary residence from the calculation of net worth for purposes of determining an individual's accredited investor status.

The Dodd-Frank Act also mandates periodic review of accredited investor standards as follows:

- Upon the first anniversary of enactment, the Dodd-Frank Act authorizes the Securities and Exchange Commission (SEC) to review and promulgate rules altering the definition of accredited investor as it relates to natural persons; however, the SEC is not authorized to adjust the net worth requirements.

- Within three years of enactment, the Government Accountability Office will be required to undertake a study, and submit a report to Congress, regarding income, net worth and other criteria for accredited investor status and the eligibility to invest in private funds.

- Upon the fourth anniversary of enactment, and every four years thereafter, the SEC must review the accredited investor standard in its entirety, including the net worth and income tests, and may subsequently alter the definition as appropriate for the "protection of investors, in the public interest, and in light of the economy." However, should the SEC retain a net worth test, the minimum threshold must exceed $1,000,000 and exclude the net value of an investor's primary residence.

While it is unclear what direction the SEC will take in the future with respect to the definition of accredited investor, the Dodd-Frank Act's immediate exclusion of a natural person's primary residence from the net worth test may significantly affect private offerings that rely on Rule 505 or 506. Any issuer that is currently in the process of a private placement where the status of individual investors as accredited is being relied upon should promptly review its subscription materials and consider obtaining new net worth representations from the prospective investors.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

Gabriella A. Lombardi (bio)
Silicon Valley
+1.650.233.4670
gabriella.lombardi@pillsburylaw.com

William T. Krause (bio)
San Francisco
+1.415.983.1597
william.krause@pillsburylaw.com