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Dodd-Frank Act Limits “Accredited Investors” in Private Placements by Excluding Value of Primary Residence from “Net Worth Test”

The Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), signed into law on July 21, 2010, changed the “accredited investor” standard for private placements exempt from registration under Regulation D. Regulation D provides safe-harbors for an exemption from registration for securities offerings at least in part to accredited investors, who are considered able to assess investment risks without the protection of disclosures made through registration. As a result of the legislative change, the value of an investor’s primary residence is now *excluded from* the “net worth test” for determining accredited investor status. This change is already in effect, with no grandfather provision for current offerings, so issuers in current and upcoming private placements should immediately revise their investor questionnaires and other subscription documents and obtain new representations to confirm the status of accredited investors.

The Securities Act of 1933 (the “Securities Act”) requires issuers of securities to register offerings, which involves onerous and costly disclosures, unless an exemption is available. Section 4(5) of the Securities Act (which was Section 4(6) until the Dodd-Frank Act renumbered it) exempts from registration certain offerings of securities made to accredited investors, and Rules 505 and 506 in Regulation D provide safe-harbors for this private placement exemption. Rule 505 permits an unregistered offering of up to \$5 million in securities to no more than 35 unaccredited investors plus an unlimited number of accredited investors. Rule 506 permits an unregistered offering for an unlimited amount of capital in a private placement of securities to no more than 35 unaccredited investors (provided that each of them, whether alone or with a purchaser representative, is financially sophisticated) plus an unlimited number of accredited investors.

A natural person’s status as an accredited investor is determined by the income test or the net worth test. Under the income test, which the Dodd-Frank Act has not changed, the definition of “accredited investor” includes any natural person with 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, as well as a reasonable expectation of reaching the same income level in the current year. Under the net worth test, any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his or her purchase exceeds \$1 million is an accredited investor.

The Dodd-Frank Act now excludes the value of an individual’s primary residence as an asset in the calculation of the individual’s net worth that determines whether the \$1 million threshold for accredited investor status under the net worth test has been met. Someone who formerly would have qualified as an accredited investor based on the net worth test may no longer qualify as an accredited investor, if his or her net worth (together with that of his or her spouse, if any) – excluding the value of his or her primary residence – is not more than \$1 million. In effect, this change significantly increases the net worth required for investors whose main asset is the value in their homes (and who do not qualify under the income test) to be accredited investors. By the same token, this change reduces the number of accredited investors eligible to buy securities in private placements.

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The Securities and Exchange Commission (the “SEC”) may not make further adjustments to the net worth standard for an accredited investor until four years after the date on which the Dodd-Frank Act was enacted. During this four-year period, however, the SEC may review and make other adjustments to the definition of “accredited investor,” including the amount required by the income test, as it deems appropriate for the protection of investors, in the public interest and in light of the economy. After the initial four-year period expires, the SEC must review the definition of “accredited investor” in its entirety at least once every four years, and it may adjust the definition further upon completing this review.

In a Compliance & Disclosure Interpretation dated July 23, 2010, the SEC announced that it would amend its rules to conform them to the new net worth standard for accredited investors required by the Dodd-Frank Act. The SEC also announced that, pending these amendments, the amount of any indebtedness secured by an investor’s primary residence, up to its fair market value, need not be counted as a liability in determining the investor’s net worth. Any indebtedness secured by the primary residence in excess of its fair market value (i.e., the amount, if any, by which a home mortgage is “underwater”), however, should be considered a liability and deducted from the investor’s net worth.

The Dodd-Frank Act also directs the SEC to issue, within one year after the date of enactment, rules that disqualify any offering or sale of securities under Rule 506 by a “person” that has been convicted of a felony or misdemeanor in connection with the purchase or sale of a security or involving a false SEC filing, or that is subject to a regulatory authority’s “bad actor” order which:

- Bars the person from associating with an entity regulated by that authority;
- Bars the person from engaging in the securities, insurance or banking business, or in savings association or credit union activities; or
- Is based on a violation, during the previous 10 years, of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct.

Clarification of the details must await the rules to be issued by the SEC, but the Dodd-Frank Act provides some guidance on which “persons” will be disqualified, by requiring these rules to be substantially similar to the disqualification provisions in Rule 262 under Regulation A, which exempts certain small offerings from registration. Under Rule 262, an offering is disqualified from the Regulation A exemption if any of the following are subject to similar sanctions:

- The issuer, any of its predecessors or any affiliated issuer;
- Any director, officer or general partner of the issuer;
- Any beneficial owner of at least 10% of any class of the issuer’s equity securities;
- Any promoter of the issuer presently connected with it in any capacity; or
- Any underwriter of the securities to be offered, or any partner, director or officer of any such underwriter.

Any further developments regarding these changes and additional rules to implement them will be the subject of further client alerts. To discuss this client alert or any securities law matter, please contact your Lathrop & Gage attorney or any of the attorneys listed below.

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