

RBA Business Law Section Practice Note

Dodd-Frank Act Modifies “Accredited Investor” Definition

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was signed into law by President Obama on July 21, 2010. Section 413 of the Dodd-Frank Act results in immediate and potentially future adjustments to the “accredited investor” definition set forth in Rules 215 and 501(a) of the Securities Act of 1933 (the “1933 Act”). Those changes could have significant implications for companies raising capital through private placements—including in offerings under Regulation D and Virginia securities exemptions that utilize the accredited investor standard (e.g., § 13.1-514(B)(19), 21VAC5-40-30, 21VAC5-40-140, 21VAC5-45-20)—and especially for companies seeking seed and angel financing from individuals.

Rules 215(e) and 501(a)(5) of the 1933 Act define an accredited investor to include any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his or her purchase of securities exceeds \$1,000,000. Effective immediately, Section 413(a) of the Dodd-Frank Act requires that the value of the primary residence of a natural person be excluded in calculating his or her net worth.* On July 23, the Securities and Exchange Commission (“SEC”) published Compliance and Disclosure Interpretations (“C&DIs”) relating to the modified net worth standard. The C&DIs clarify that (a) in excluding the value of a person’s primary residence, “the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded”, and (b) any such indebtedness that exceeds the value of the residence is a liability and should be deducted from the person’s net worth.

This adjustment to the net worth standard undoubtedly will cause some natural persons to cease to qualify as accredited investors, which in turn will reduce the number of investors that are eligible to participate in certain offerings (e.g., offerings made only to accredited investors under Rule 506 of Regulation D). It also may affect entity investors that rely on Rules 215(h) and 501(a)(8) for their accredited investor status. Those rules define “accredited investor” to include any entity in which all of the equity owners are accredited investors.

Companies that conduct securities offerings in the future for which accredited investor status is relevant—and their counsel—need to ensure that their offering documents (e.g., private placement memoranda, subscription agreements, investor qualification questionnaires) reflect the revised net worth standard under the Dodd-Frank Act and C&DIs. For any such offerings that were ongoing when the Dodd-Frank Act was adopted, issuers need to confirm that all post-enactment subscribers who rely on the net worth standard as a basis for their accredited investor status continue to qualify under the modified standard and also should consider supplementing their offering documents to conform to the Frank-Dodd Act and C&DIs.

The Dodd-Frank Act also may result in future changes to the definition of accredited investor. Section 413(b)(1) of the Dodd-Frank Act authorizes the SEC to review the accredited investor definition as it applies to natural persons and to adjust the definition (excluding any modification to the net worth standard described above) as the SEC deems appropriate for the protection of investors, in the public interest, and in light of the economy. Section 413(b)(2) requires the SEC to review the accredited investor definition as it applies to natural persons not earlier than 4 years after the enactment of the Dodd-Frank Act, and not less frequently than once every 4 years thereafter, and adjust the definition as the SEC deems appropriate.

David M. Lay
LeClairRyan

* The Dodd-Frank Act does not make any other immediately effective changes to Rules 215 and 501(a) of the 1933 Act. Without limitation, it does not modify Rules 215(f) or 501(a)(6), which define an accredited investor to include 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 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 current year.