

The Changing Definition of “Accredited Investor” Under the Dodd-Frank Act

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On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), weighing in at more than 800 pages. The Dodd-Frank Act signals sweeping changes to the financial services industry, including significant alterations to the method of determining the \$1 million net worth threshold for accredited investors. In addition, Congress provided a roadmap for possible future adjustments to the definition of “accredited investor.”



Modifications to the Net Worth Standard

Prior to the Dodd-Frank Act, the requirements for a natural person to qualify as an accredited investor had remained the same since their promulgation in 1982: a net worth of more than \$1 million (including personal residence) or recent annual income in excess of \$200,000 or \$300,000 (depending on marital status), with a reasonable expectation of maintaining that income level. In recent years, some observers suspected that more than a quarter century of inflation and real estate appreciation had watered down these thresholds. In response, the Dodd-Frank Act modifies the \$1 million net worth standard by excluding the value of the investor’s primary residence. This definitional change is intended to increase investor protection by limiting participation in private securities offerings to investors who are capable of evaluating the risks of such offerings. The Dodd-Frank Act does not affect the accredited investor income levels.

Although the Dodd-Frank Act excludes the value of a person’s home from the net worth standard, it does not provide for how real estate debt should be treated. The U.S. Securities and Exchange Commission (SEC), however, has issued guidance on this point:

- If the related amount of indebtedness secured by the primary residence is less than or equal to the home’s fair market value, then it is not considered in determining net worth.
- If, however, the related amount of indebtedness exceeds the fair market value of the home, then it should be deducted from the person’s net worth.

Future Changes

The Dodd-Frank Act also calls for future changes to the definition of the term “accredited investor” and directs an increase in the \$1 million threshold in four years (though it must remain at \$1 million during those four years). After four years, the SEC is required to review the “accredited investor” definition in its entirety to establish if it should be adjusted for the protection of investors, in the public interest and in light of the economy. Any adjustments or modifications will be made through the notice and rulemaking process with subsequent reviews at least every four years.

It should be noted that, other than the \$1 million net worth requirement, the Dodd-Frank Act authorizes the SEC to adjust or modify the definition of the term “accredited investor” for natural persons at any time. In addition, it requires the Government Accountability Office (GAO) to conduct a study on the appropriate criteria for determining the financial thresholds to qualify for accredited investor status and eligibility to invest in private placements. The GAO will report the results of its study to Congress no later than July 21, 2013, three years after enactment of the Dodd-Frank Act. The GAO report may factor significantly into calculating the total increase in the \$1 million threshold in 2014.

At This Juncture of the Dodd-Frank Act

What is known:

- The value of a person’s home can no longer be included in determining that person’s net worth;
- The SEC is authorized to adjust or modify the definition of “accredited investor” during the next four years; and
- The SEC is required to review the definition of “accredited investor” in its entirety in four years.

What remains to be seen:

- The impact of current and future changes to the accredited investor standard on the day-to-day practices of financial services firms.

Immediate Concerns

Because there was no delay in its enactment, the net worth provision has an immediate impact on those issuers raising capital by offering private placements exclusively to accredited investors via Regulation D exemptions. One likely effect is that the pool of accredited investors will shrink. Excluding personal residence from the net worth calculation necessarily reduces the number of eligible investors. And, as the SEC stated in its 2007 proposal, inflation-adjusted net worth or annual income standards would “significantly reduce the number of U.S households that are eligible to invest in private investment vehicles.” A smaller investor pool could reduce capital available to issuers, particularly smaller companies that rely on lesser sums of money from natural persons.

Another immediate concern is accurately qualifying investors. Private placement memoranda, subscription documents and other qualifying forms may contain disclosures and representations regarding investor eligibility. Some restate the “accredited investor” definition, and others go as far as requiring an investor to evidence his or her net worth on a calculation worksheet. Although the new standard does not apply to investors who qualified prior to the Dodd-Frank Act and remain passive or sell their shares, issuers and distribution partners, such as



broker-dealer selling firms and third-party administrators, may wish to evaluate pending subscription requests to confirm that a potential investor remains qualified while excluding his or her primary residence or qualifies via another standard.

In addition, financial services firms may wish to reevaluate the eligibility of existing investors who qualified prior to the Dodd-Frank Act and want to purchase additional shares. At the same time, broker-dealer selling firms may consider using the opportunity to update investor account information to maintain accurate records and aid in future suitability and eligibility analysis. Going forward, documents that contain the former definition may need to be amended to reduce the risk that an issuer accepts subscriptions from non-accredited investors and jeopardizes its Regulation D exemption or safe harbor. Supplementing documents, rather than preparing a full reprint may be a cost-effective way to update the information quickly.

Taking an Active Role

The SEC is currently accepting, via its Web site, public comments on all initiatives required by it under the Dodd-Frank Act, including the accredited investor standard. It remains to be seen whether or not the SEC will prioritize this aspect of the Dodd-Frank Act and make immediate changes to the other accredited investor standards. Those who would like to take an active role in the outcome may wish to submit comments directly to the SEC or provide their insights and opinions to industry groups and outside counsel involved in formulating the issues.

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