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SEC Update

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Potential Hidden Implications of Registration Act Revisions to Accredited Investor Standard

As we discussed in our July 23, 2010 Investment Management Alert, Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1], titled "Private Fund Investment Advisers Registration Act of 2010" (the "Registration Act") revised the "net worth" test that may be used by individual investors seeking to assert "accredited investor" status for purposes of Regulation D under the Securities Act of 1933, as amended.

More Restrictive "Net Worth" Test; Further Refinement May Be Needed

Amendments under the Registration Act require an individual seeking to comply with the "net worth" test set forth in Regulation D Rule 501(a)(5) to exclude the value of such person's primary residence from their net worth calculation. Unlike other Registration Act provisions, this revision was immediately effective. The Securities and Exchange Commission ("SEC") Division of Corporation Finance has issued guidance clarifying that mortgage and other indebtedness secured by a primary residence should be excluded from the liability side of an individual's net worth calculation up to the fair market value of such residence, but indebtedness secured by the primary residence in excess of the home's fair market value must be included as a liability and deducted from an individual investor's net worth[2]. The SEC's compliance bulletin ostensibly was prepared in response to concerns about unfairly having to count mortgage and other liabilities without counting the offsetting asset.

The amended "net worth" test, while presumably designed to make it more difficult for individuals to qualify as accredited investors merely from the unprecedented appreciation in home values over the last two decades, also oddly creates an incentive for individuals who may be well-positioned to payoff all or substantial portions of their mortgage, to retain such cash outside the home (where it would be a countable asset) if they desire to invest in funds and other private placements. The individual's net worth would be identical in both instances, but the Registration Act focuses on the value of the home and not an individual's funded equity in the home. Perhaps further rulemaking might address this inconsistent and unintended outcome.

An Inability to Fall Within the Regulation D Safe Harbor Could Have Significant Consequences; Prepare For Increased Scrutiny of Your Private Placement Process

While the revised "net worth" test may be viewed as simply a narrow revision within Regulation D, a failure to adhere to all of the safe harbor's requirements, including the requirement for an issuer engaging in a Rule 506 offering to not exceed 35 purchasers (which include non-accredited investors, but not accredited investors), could have significant consequences for an issuer, including (1) heightened disclosure requirements triggered when soliciting non-accredited investors and (2) potential registration and qualification of the issuer's securities with individual states pursuant to state "blue sky" laws and consequent substantive regulation of offering documents by the states[3]. Additionally, in light of increased enforcement by the SEC and efforts under the Registration Act to narrow exemptions from registration for private fund advisers (thus increasing the SEC's access to more private fund advisers), we anticipate further regulatory scrutiny with respect to how private fund issuers incorporate these revisions into their sales and compliance processes (generally speaking, to assess the extent to which they are sensitive to private placement requirements) and more generally into the manner and nature of private placement offerings.

Establishing the Reasonable Basis; Existing Investor Questionnaires and Offering Documents Must Be Immediately Updated; Review Front-End Offering Processes and Controls

Issuers should be alert to avoid inadvertent use of obsolete materials that could undermine their ability to rely on the Regulation D safe harbor. In our July 23rd Alert, we suggested, among other things, that fund managers and financial service organizations update their existing offering documents to ensure that, where discussed, the definition of "accredited investor" accurately reflects the revised standard and to review internal training materials and supervisory procedures to ensure they are appropriately updated (and to potentially consider this an opportune time to evaluate their effectiveness). More importantly, issuers should review and update their investor questionnaires and other investor identification, seasoning and pre-qualification procedures.

Representations provided by investors in subscription agreements regarding their financial status are a helpful means for documenting, in writing, the basis by which a person is, in fact, accredited, but subscription documents largely serve as back-end verification. On the front end, prior to actually making an offer, an issuer is likely to come across other more factual information about a person's occupation, income potential, primary residence, and other assets, through their relationship with such person prior to delivery of offering

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documents (including the subscription agreement). In fact, in a series of interpretations, the SEC Staff has contemplated that issuers (or their agents) relying upon Regulation D in an effort to avoid a "general solicitation" should establish both a preexisting and substantive relationship with prospective offerees prior to making an offer. A substantive relationship is established when an issuer or its agent has "sufficient information to evaluate the prospective offeree's sophistication and financial circumstances." The information learned during this process should be evaluated by an issuer in determining whether or not it has a reasonable basis to believe a person is accredited before providing offering materials and should be contrasted with the representations made by an individual in the subscription agreement (and relevant pre-qualification questionnaires) and, where applicable, further inquiry should be made.

Please call us if you have any questions regarding your private placement policies and compliance review processes or to otherwise discuss the implications of the Registration Act.

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(1) Public Law 111-203; July 21, 2010; 124 Stat. 1376.

(2) Compliance and Disclosure Interpretation 179.01 (July 23, 2010).

(3) Securities Act Section 18(a)(1)(A) preempts state regulation requiring the registration and qualification of certain securities offerings, including those of "covered securities." Covered securities is defined to include securities sold pursuant to Regulation D and other rules and regulations issued under Securities Act Section 4(2), but not securities otherwise offered pursuant to Section 4 (2). Even though an issuer falling outside the Regulation D safe harbor may still engage in a Section 4(2) private offering, such issuer may still face state "blue sky" regulation of its offering.