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Revised Natural Person Accredited Investor Standard Applies Immediately

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Among others, the Dodd-Frank Act revised the “accredited investor” definition under Rule 215 of the Securities Act of 1933, as amended (the “Securities Act”) and Rule 501 of Regulation D promulgated under the Securities Act as it relates to *natural persons* to exclude the value of a person’s primary residence from the net worth test.

Value of One’s Primary Residence Is Excluded under the New Net Worth Test

Pursuant to the net worth test, an individual qualifies as an “accredited investor” if it has a net worth test of \$1 million. The value of an investor’s primary residence was previously included in its net worth. From now on, it will be excluded.¹ This revision of the “accredited investor” standard is *effective immediately* and may likely significantly increase the net worth requirement for many investors that are natural persons. There is no transition period or grandfathering for private offerings that are already in progress and, consequently, asset managers and other issuers currently conducting private placements should revise their subscription documents and offering memoranda immediately to reflect this modification of the net worth test. In particular, sponsors of open 3(c)(1) funds should now update their offering memoranda.

Staff of the Securities and Exchange Commission (the “Commission”) has informally expressed the view that the Commission, in applying the \$1 million net worth test, will allow investors to exclude any mortgage or any other debt secured by the investor’s primary residence that does not exceed the fair market value of the residence. If, however, the amount of such debt exceeds the fair market value of the residence and the lender has recourse to the investor personally for any deficiency, investors would be required to include the excess liability from the net worth calculation.

Impact on New Investors and Existing Investors Making New Capital Contributions

We expect that the revision of the accredited investor standard will apply only to new investors or existing investors that are making new contributions. Accordingly, no re-certifications should be necessary from existing investors that are not making additional contributions. With regard to private equity funds, new capital commitments should be accepted only from investors who satisfy the new accredited investor standard. We will inform you of any Commission guidance issued on these matters.

¹ Section 413(a) of the Dodd-Frank Act.

Note that the “net worth” test is only one of the tests that an individual investor must meet to satisfy the definition of an “accredited investor.” The Dodd-Frank Act does not change the “income test” for individuals, which remains \$200,000 (or \$300,000 jointly with one’s spouse) in each of the last two years, if such individuals have a reasonable expectation of reaching the same income level in the current year. The criteria for investors that are not natural persons, such as corporations and other entities, are also unchanged by the Dodd-Frank Act.

The exclusion of the value of an individual’s primary residence from the net worth test shall be in effect during the 4-year period following enactment of the Dodd-Frank Act. However, the Commission may reevaluate the definition of “accredited investor” as it relates to natural persons² and must review the definition in its entirety as defined in Rule 215 of the Securities Act as it relates to natural persons³ at least every four years and, thus, such criteria may be revisited at a later stage. Moreover, the Comptroller General of the United States is required to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds, and must submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the results of such study not later than 3 years after the date of enactment of the Dodd-Frank Act.⁴

If you have any questions regarding this client alert, or require assistance with any other issue relating to private funds and investment advisory issues, please contact the authors Linda Smith (ls@garritygraham.com; (973) 576-9614) and Roderick J. Cruz (rc@garritygraham.com; (973) 576-9615), or any of the members of the Investment Management practice group:

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² Section 413(b)(1) of the Dodd-Frank Act.

³ Section 413(b)(2) of the Dodd-Frank Act.

⁴ Section 415 of the Dodd-Frank Act.



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