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Corporate Governance Group Client Alert

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"ACCREDITED INVESTOR" STANDARD FOR REG D OFFERINGS TIGHTENED BY WALL STREET REFORM ACT

New legislation also bars certain "bad actors" from engaging in Reg D offerings

As discussed in a previous Client Alert,[1] the recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "*Wall Street Reform Act*") is a far-reaching piece of legislation that, in many respects, extends beyond regulation of the financial services industry and its products. For instance, the legislation impacts, in two respects, the Regulation D ("*Regulation D*") safe harbor for private placements of securities exempt from registration under the Securities Act of 1933, as amended (the "*Securities Act*"):

- Section 413 of Title IV (denominated "*Regulation of Advisers to Hedge Funds and Others*") tightens the "accredited investor" standard contained in Section 501(a)(5) of Regulation D ("*Section 413*").
- Section 926 of Title IX (denominated "*Investor Protections and Improvements to the Regulation of Securities*") calls upon the Securities and Exchange Commission (the "*Commission*") to adopt rules limiting the availability of the Regulation D safe harbor to certain "Felons and Other 'Bad Actors'" ("*Section 926*").

"*Accredited Investor*" *Standard*

Regulation D sets forth several categories of "accredited investors" who, based on their financial standing and/or sophistication, are deemed not to be in need of the protections afforded by Securities Act registration. Included among the accredited investors is "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, … exceeds $1,000,000."

[1] *See* our Client Alert entitled "Corporate Governance Highlights of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010," dated July 21, 2010.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided at the end of this alert.

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Section 413 provides that the calculation of an individual's net worth for this purpose shall (effective immediately) exclude "the value of the primary residence of such natural person." This modification obviously was inspired by the recent financial crisis and reflects the resulting skepticism over the value of individual residences. As a result, going forward, issuers conducting private placements will not be able to include the value of a potential individual investor's primary residence when calculating whether such investor has sufficient net worth to qualify as an accredited investor. Section 413 also calls upon the Commission to periodically review Regulation D's net worth standard and consider modifications "appropriate for the protection of investors, in the public interest, and in light of the economy."

As in the case with many provisions of the Wall Street Reform Act, there are several unanswered questions raised by Section 413. To address one of these questions, the Staff of the Commission recently offered interpretive guidance which has been posted on the Commission's website. Specifically, the Staff noted that Section 413 does not address the impact on an investor's net worth of mortgages and other indebtedness that may be secured by the investor's primary residence. Pending the issuance of amendments to Regulation D to reflect the new accredited investor standard, the Staff indicated that any such secured indebtedness, in an amount up to the "fair market value" of the residence, may be ignored when calculating an individual's net worth. However, any such secured indebtedness in excess of the "fair market value" of the residence must be "considered a liability and deducted from the investor's net worth."

"*Felons and Other Bad Actors*"

Section 926 calls upon the Commission, within a year's time, to issue rules that would disqualify so-called "felons and other bad actors" from utilizing Rule 506 under Regulation D (which encompasses all such offerings in excess of $5 million). "Felons and other bad actors" include any person that:

"(A) is subject to a final order of a State securities commission (or an agency or officers of a State performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or an agency or officer of a State performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration, that:

(i) bars the person from:

(I) association with an entity regulated by such commission, authority, agency, or officer;

(II) engaging in the business of securities, insurance, or banking; or

(III) engaging in savings association or credit union activities; or

(ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offer or sale; or

(B) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission."

These restrictions are similar to limitations applicable to Regulation A offerings under the Securities Act, and Section 926 in fact directs the Commission to model its rules on the applicable Regulation A provisions. However, because the Regulation D safe harbor is more widely used than Regulation A, the rules promulgated pursuant to Section 926 will have more of a practical impact on issuers of securities.

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We will discuss the actual amendments to Regulation D (as well as other Commission rule making touching upon corporate governance issues in response to the Wall Street Reform Act) when they are made public by the Commission.

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