

MEMORANDUM

TO: Our Colleagues and Clients

DATE: August 2010

SUBJECT: ALERT: Revised Regulation D Accredited Investor Standards

While “Private Fund Investment Advisers Registration Act of 2010” is the title of Article IV of HR. 4173, the recently signed Wall Street Reform and Consumer Protection Act, it includes provisions not limited to hedge funds, with some of them having broad implications from all securities professionals. We would like to bring to your attention the following important change which became effective on July 21, 2010, the date of signing the bill. We anticipate circulating and posting additional memoranda as the regulatory agenda becomes more defined.

Under Regulation D there have always been two alternative tests for “Accredited Investors” who are natural persons. (either one suffices). One of them is the income test: gross income of \$200,000 or more (or, combined income with spouse of \$300,000 or more) in each of the last two tax years and a reasonable expectation of meeting that standard in the current tax year. The Act does not change this test.

The other test for natural persons is the “net worth test,” which could be satisfied by the investor, alone or together with his/her spouse, having a net worth in excess of \$1,000,000 at the time of the investment. Under the newly signed Act, the net worth standard under Regulation D for natural persons to qualify as “Accredited Investors” will continue to be \$1,000,000, but the Act specifically provides that the calculation of net worth must exclude the value of the investor’s primary residence. Mortgage debt associated with a primary residence may be disregarded in the investor’s net worth calculation providing the debt is not more than the current market value of the residence. (If, however, the mortgage debt is more than the value of the residence, the excess must be included as a liability in the net worth calculation.)

The revised standard will apply both to new investors and to current investors making additional investments (because they, too, must be accredited investors *at the time of the additional investment*). We assume that revised Accredited Investor standards set by the states will follow. Accordingly, offering documents and investor questionnaires should immediately be reviewed and updated. Consideration should be given to alerting investors of the changes to the net worth standard for natural persons. While neither the income standard for natural persons nor the standards for entity accredited investors have been amended, both the SEC and GAO are mandated by the Act to study and recommend revised appropriate criteria for Accredited Investors.

In a related development, the Act requires the SEC to periodically adjust, for inflation, the definition of “qualified client”¹ under Rule 205-3 under the Investment Advisers Act of 1940. The rule currently allows investment advisors who enter into advisory contracts with qualified clients to be compensated based on a share of capital gains or capital appreciation. Given that the Act will require many investment advisors with hedge funds as clients to register with the SEC (and thus be subject to the provisions of the Investment Advisers Act), the definition of “qualified client” may affect the compensation of hedge fund managers. Additionally, under the Act all investment advisors – even if not required to be registered – will be subject to certain recordkeeping and other rules, and may be required to produce them to the SEC upon request.

In a relief from the regulatory burdens of the new law, the Act permanently exempts issuers that are neither a “large accelerated filer” nor an “accelerated filer,” from the Section 404(b) requirements of Sarbanes-Oxley that an external auditor attest to internal control over financial reporting.

The Act also requires the SEC to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for issuers whose market capitalization is between \$75 million and \$250 million.

If you have any questions, please feel free to call our office.

¹ The term *qualified client* means:

i. A natural person who or a company that immediately after entering into the contract has at least \$ 750,000 under the management of the investment adviser;

ii. A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes,:

A. Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$ 1,500,000 at the time the contract is entered into.