SEC Finalizes Net Worth Standard for Accredited Investors

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The Securities and Exchange Commission (the "SEC") has adopted new rules for calculating whether an individual is eligible to participate in certain unregistered securities offerings as an "accredited investor", as defined in Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), by virtue of having a net worth exceeding $1,000,000. These rules are intended to comply with Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted on July 21, 2010, which directed the SEC to amend its definition of accredited investor to exclude the value of an individual's principal residence from the calculation of such individual's net worth. Before Dodd-Frank, the value of an individual's principal residence was included in calculating the individual's net worth.

The final rules are consistent with the intent of Dodd-Frank, but introduce new concepts which must be understood by both issuers and investors. The new rules will be effective 60 days after publication in the Federal Register.

Initial Proposal
In January 2011, the SEC initially proposed rules that would satisfy Dodd-Frank's mandate by providing that in calculating whether an individual has a net worth of more than $1,000,000, either alone or jointly with a spouse:

- the individual's principal residence would not be included as an asset;
- indebtedness that is secured by the person's primary residence and that does not exceed the estimated fair market value of the primary residence would not be included as a liability; and
- any indebtedness in excess of the estimated fair market value of the primary residence would be counted as a liability.

Final Rules
The SEC's final rules adopted the initial proposal, with two modifications:

- First, to discourage investors from converting their home equity into cash just prior to an investment in order to achieve accredited investor status, the final rules provide that if the total amount of indebtedness secured by the individual's primary residence at the time of the sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of the excess will be included as a liability.
- Second, to address commenters' request for a grandfathering provision, the final rules provide an exemption for an individual's exercise of a pre-existing

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right to purchase, provided that the individual held such right on July 20, 2010, the person qualified as an accredited investor on the basis of net worth at the time the person acquired such right, and the person held securities of the same issuer, other than such right, on July 20, 2010. While this grandfathering provision will facilitate the exercise of convertible securities and other binding rights that were issued prior to the enactment of Dodd-Frank, it is important to note the requirement that the investor held other securities of the same issuer on July 20, 2010. Grandfathering is not available to an investor that on July 20, 2010 held only the right, and no other securities of the issuer.

As under the initial proposal, whether an individual is an accredited investor may depend on how the individual's assets are invested. For example, if an investor has $1.2 million invested in securities, and a principal residence valued at $1.2 million that is fully mortgaged, he will be considered an accredited investor. However, he will not be considered an accredited investor if he decides to liquidate his portfolio of securities and use the proceeds to pay down his principal residence's mortgage.

Action Items

Companies that issue securities to accredited investors in reliance upon exemptions from Securities Act registration requirements should:

- update their subscription and other investment agreements to incorporate the new definition of accredited investor;
- review the terms of any outstanding rights to acquire securities, such as warrants, stock options and convertible securities, that permit exercise by accredited investors, to determine whether any amendments are required; and
- where the company intends to rely on "bring down" representations from an accredited investor to verify eligibility for a new investment, ensure that the investor is aware of, and the bring down representations comply with, the new definition.

A complete copy of the SEC adopting release can be found here.

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