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SEC Amends Net Worth Standard for Accredited Investors

On December 21, 2011, the US Securities and Exchange Commission (the "SEC") amended its rules to exclude the value of an individual's primary residence from net worth calculations used to determine whether an individual qualifies as an "accredited investor" on the basis of having a net worth in excess of US$1 million. These amended rules implement Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and are consistent with the SEC Staff's initial analysis of Section 413(a) as set forth in the Securities Act Rules Compliance & Disclosure Interpretation released in July 2010.[1] The amended rules will become effective 60 days after publication in the Federal Register, however, the requirement to exclude the value of a primary residence for this purpose became effective on July 21, 2010, the day the Dodd-Frank Act was signed into law. The SEC will review the "accredited investor" definition in its entirety every four years, commencing in 2014, pursuant to the Dodd-Frank Act's requirements. The SEC is empowered to make additional modifications to the definition based on such future review.

Former Net Worth Standard for Accredited Investors

"Accredited investor" standards are set forth in Rules 215 and 501 under the Securities Act of 1933, as amended (the "Securities Act"), and are used in determining the availability of certain exemptions from Securities Act registration for private and other limited offerings, such as those under Rules 505 and 506 of Regulation D. SEC rules permit such offerings to be made without registration, and without requiring specified disclosures, if sales are made only to "accredited investors."

One way individuals may qualify as "accredited investors" is by having net worth, alone or together with their spouse, of at least US$1 million.[2] The SEC has stated that the accredited investor standard serves to identify persons who can bear the economic risk of an investment in unregistered securities. Under the prior accredited investor standard, an individual investor and his or her spouse were permitted to include the net equity value of their primary residence in calculating whether they qualified for accredited investor status.

1 *See* Securities Act Rules Compliance & Disclosure Interpretation, Question No. 255.47 (July 23, 2010) (available at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#255.47).

2 *See* Rule 215(e) and Rule 501(a)(5) under the Securities Act.

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Amended Net Worth Standard for Accredited Investors

Section 413(a) of the Dodd-Frank Act requires the SEC to adjust the net worth standard for natural persons, individually or jointly with their spouse, to more than US$1 million, excluding the value of the primary residence. While Section 413(a) of the Dodd-Frank Act became effective immediately upon enactment of the Dodd-Frank Act on July 21, 2010, the SEC was required to subsequently amend its rules to conform to the new standard.

Following the SEC's review of comments received in response to its proposing release, the SEC amended rules 215 and 501 of the Securities Act such that the "accredited investor" US$1 million net worth standard excludes the value of an individual's primary residence when calculating net worth. In addition, under the amended net worth standard's calculation, indebtedness secured by an individual's primary residence, up to the estimated fair market value of the primary residence, is not treated as a liability, except if the borrowing occurs in the 60 days preceding the purchase of securities in the exempt offering and is not in connection with the acquisition of the primary residence.

The SEC believes that the term "primary residence" has a commonly understood meaning as the home where a person lives most of the time, and therefore, did not adopt a definition of such term in connection with the amendments.

Limited Grandfathering of the Prior Net Worth Standard

Under certain circumstances, the amendments permit individuals who qualified as accredited investors under the pre-Dodd-Frank Act definition of net worth to use that prior net worth standard for certain follow-on investments. Specifically, individuals who qualified as "accredited investors" prior to the enactment of the Dodd-Frank Act may use the prior net worth standard where (1) the person held a right to purchase the securities on July 20, 2010; (2) the person qualified as an "accredited investor" on the basis of net worth when they acquired such right and (3) the person held securities of the issuer (other than such right to purchase) on July 20, 2010.

Conclusion

The amended rule's exclusion of an individual's primary residence from the net worth calculation will likely result in some investors who had previously qualified for accredited investor status no longer being able to qualify as such. When individual investors are proposed to be included in an unregistered securities offering on the basis of their accredited investor status, issuers should ensure that those individuals are aware of the new standard by including an updated definition in the accredited investor questionnaire and, if possible, in the representations contained in any investment agreement.