SEC ADOPTS RULES MODIFYING THE NET WORTH STANDARD FOR "ACCREDITED INVESTORS"

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On December 21, 2011, the Securities and Exchange Commission (SEC) adopted amendments to the definition of "accredited investor" under Regulation D of the Securities Act of 1933, as amended (Securities Act), to implement the requirements of Section 413(a) of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The Dodd-Frank Act, along with the SEC's amendments, exclude the value of a person's primary residence in determining whether the person qualifies as an "accredited investor" under Regulation D on the basis of having a net worth of more than $1 million for purposes of participating in certain securities offerings that are not registered under the Securities Act. As a result, the Dodd-Frank Act and recent amendments to Regulation D have narrowed one of the primary means historically used by individuals to qualify as accredited investors in order to participate in private placements of securities. The SEC amendments will go into effect 60 days after publication in the Federal Register.

BACKGROUND

Regulation D contains three safe harbors – Rules 504, 505 and 506 – that allow issuers to offer and sell their securities without registering the securities with the SEC. While Rules 504 and 505 limit the size of offerings to $1 million and $5 million, respectively, Rule 506 permits issuers to sell an unlimited amount of securities. Moreover, each rule permits issuers to sell securities to an unlimited number of accredited investors. Rules 505 and 506, however, limit the number of non-accredited investors that may participate in a particular offering to 35.

In addition, prior to selling securities to non-accredited investors under Rules 505 and 506, issuers are required to provide the investors with detailed disclosure documents that are generally as extensive as those used in offerings registered with the SEC, whereas Rules 505 and 506 provide issuers with discretion in determining the type and amount of information to provide accredited investors in connection with securities offerings. As a result of the cost and time involved in preparing more detailed disclosure, many issuers conducting private placement offerings seek to limit participation to accredited investors only. One of the primary means by which a natural person can qualify as an accredited investor under Regulation D is if that person's individual net worth, or joint net worth with that person's spouse, exceeds $1 million at the time of purchase of the securities.[1]

ADOPTING RELEASE

Prior to the enactment of the Dodd-Frank Act, individuals were permitted to include the value of their primary residence in calculating their net worth. Section 413(a) of the Dodd-Frank Act amended the prior definition of "accredited investor" as of July 22, 2010 to exclude the value of the investor's primary residence when calculating net worth. The final rule amendments adopted by the SEC (the "Adopting Release")[2] implement these changes under the Securities Act and specifically provide that:

- the person's "primary residence"[3] shall not be included as an asset;
- indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability, except that if the amount of such indebtedness outstanding 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 such excess shall be included as a liability; and
- indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability.

Treatment of Mortgage Debt

Consistent with the SEC's proposed rule amendments set forth in a release dated January 25, 2011[4], the final rule amendments provide that any positive equity that an individual has in his or her primary residence shall be excluded from the individual's net worth calculation, while any excess of indebtedness secured by the individual's primary residence over the estimated fair market value of the residence is considered a liability for purposes of calculating the individual's net worth. In the Adopting Release, the SEC clarified that the excess indebtedness must be excluded even if the laws of the state in which the individual's primary residence is located would prohibit a lender from seeking repayment from the individual's other assets if the individual's mortgage goes into default. In addition, the SEC clarified that the rules do not require a third party opinion or valuation for purposes of determining the fair market value of either the primary residence or any other assets or liabilities, and that all that is required for purposes of the net worth calculations is an estimate of the fair market value of the asset.

The final rule amendments also require prospective investors to take into account any increase in the amount of debt secured by a primary residence in the 60 days prior to the sale of securities. In the event the amount of debt secured by a primary residence on the date the securities are sold is greater than the amount of debt secured by that primary residence on the date that is 60 days prior to the date the securities are sold, the amount of the additional debt generally is treated as a liability in calculating net worth regardless of whether the estimated value of the primary residence exceeds the aggregate amount of debt secured by such primary residence at the time the securities are sold.

The Adopting Release states that the purpose of this 60-day look-back is to deter individuals from manipulating their net worth by borrowing against their primary residence shortly before seeking to qualify as an accredited investor, as well as to deter issuers and agents from encouraging individuals to incur additional debt secured by their primary residence simply to facilitate investments in securities.

The final rule amendments include an exception, however, for increases in debt resulting solely from the acquisition of a primary residence during the 60-day period. Therefore, if an individual acquires a new primary residence during the 60-day look-back period, he or she will not be required to automatically treat the entire amount of indebtedness incurred in connection with the acquisition of the primary residence as a liability for purposes of calculating net worth. Nonetheless, the individual will still be required to exclude the value of the primary residence from his or her net worth calculation and treat any excess of indebtedness secured by the primary residence over the estimated fair market value of the residence as a liability for purposes of calculating net worth.

The following examples are used to illustrate the final rule amendments:

Example 1:

Assuming an investor's primary residence, held for more than 60 days, has an estimated fair market value of $500,000 and has secured indebtedness of $600,000 and none of the secured indebtedness was incurred within 60 days prior to the sale of the securities, then $500,000 of the indebtedness would be offset by the value of the primary residence. The remaining $100,000 of indebtedness would be treated as a liability and subtracted from the investor's other assets in determining the investor's net worth.

Example 2:

Assuming an investor's primary residence, held for more than 60 days, has an estimated fair market value of $500,000 and has secured indebtedness of $400,000 and none of the secured indebtedness was incurred within 60 days prior to the sale of the securities, the $500,000 value of the primary residence would not be added to the investor's net worth and the $400,000 of indebtedness also would not be subtracted from the investor's net worth (in other words, the $100,000 difference would be excluded entirely from the calculation of the investor's net worth).

Example 3:

Assuming an investor's primary residence, held for more than 60 days, has an estimated fair market value of $500,000 and has secured indebtedness of $400,000, of which $75,000 in indebtedness was incurred within 30 days prior to the sale of securities, $75,000 of indebtedness would be treated as a liability and subtracted from the investor's other assets in determining the investor's net worth.

Example 4:

Assuming an investor's primary residence, held for more than 60 days, has an estimated fair market value of $500,000 and has secured indebtedness of $600,000, of which $300,000 in indebtedness was incurred within 30 days prior to the sale of securities, $300,000 of indebtedness would be treated as a liability (not $100,000) and subtracted from the investor's other assets in determining the investor's net worth.

Transition Rules

The final rule amendments also provide for grandfathering of the prior net worth standard in limited circumstances. Specifically, the amendments permit issuers and investors to use the accredited investor net worth test in effect immediately prior to the adoption of the Dodd-Frank Act for certain subsequent or "follow-on" investments if:

- the securities are sold to an investor pursuant to a contractual right to purchase held by the investor on July 20, 2010 (the day before the Dodd-Frank Act was enacted);
- the investor qualified as an accredited investor on the basis of net worth at the time the person acquired the contractual right (based on the net worth standards in effect at the time the right was acquired); and
- the investor held securities of the same issuer, other than the contractual right, on July 20, 2010.

Accordingly, the grandfathering rule is relatively limited in that it applies only to an individual who qualified as an accredited investor on the basis of net worth at the time the relevant right was originally acquired. In the Adopting Release, the SEC stated that the grandfathering provision will generally apply to the following types of rights:

- statutory rights, such as pre-emptive rights arising under state law;
- rights arising under an entity's constituent documents; and
- contractual rights, such as rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible instrument, rights of first offer or first refusal and contractual pre-emptive rights.

REVISITING THE DEFINITION OF "ACCREDITED INVESTOR"

Section 413(a) mandates that, through July 21, 2014, the four-year anniversary of the adoption of the Dodd-Frank Act, the net worth standard shall continue to be more than $1 million, excluding the value of the investor's primary residence. This Section requires that the SEC undertake a review of the definition of "accredited investor" in its entirety after July 21, 2014 and again no less frequently than once every four years thereafter "to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." Therefore, the net worth formula will again be open to review by the SEC beginning in July 2014 and may be adjusted further at or after that time.

ADVICE FOR ISSUERS

Now that the SEC has adopted the final rule amendments, issuers should consider the following actions:

- Ensure that their "accredited investor" eligibility questionnaires reflect the final rule amendments and specifically include language clarifying how a person's primary residence, and any related indebtedness, is factored into calculating "net worth" under the final rule amendments. To illustrate the final rule amendments, issuers may wish to provide a series of hypothetical calculations in their eligibility questionnaires.
- Be cautious when seeking to use the prior "net worth" definition for certain follow-on offerings. Even though an individual may have qualified as an accredited investor under Regulation D at the time the contractual right to participate in a future financing was acquired, the final rule amendments specifically require that the individual met the net worth requirements of the accredited investor test at the time the right was acquired. Issuers should require that investors certify as having met this requirement at the time the contractual right was acquired prior to relying on the grandfathering provision.
- When granting a contractual right to participate in one or more future private placements of securities, notify the holder that the right to participate may be contingent upon the holder qualifying as an accredited investor at the time of the future offering, and that the requirements for meeting the accredited investor standard at the time of such offering may be different (i.e., more burdensome on the investor) than the accredited investor standards in effect at the time the contractual right to participate was granted.

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[1]Individuals can also qualify as accredited investors if, for example, they had an income of at least $200,000 in each of the two most recent years (or $300,000 together with their spouse) and have a reasonable expectation of reaching the same income level in the current year.

[2] Net Worth Standard for Accredited Investors, SEC Release No. 33-9287, December 21, 2011. Available at http://www.sec.gov/rules/final/2011/33-9287.pdf.

[3] In the Adopting Release, the SEC indicated that an individual's "primary residence" is commonly understood to mean the home where a person lives "most of the time."

[4] Net Worth Standard for Accredited Investors, SEC Release No. 33-9177, January 25, 2011. Available at http://www.sec.gov/rules/proposed/2011/33-9177.pdf (the "Proposing Release"). For additional background on the Proposing Release and a summary of the comment letters received by the SEC in response to the Proposing Release, see our prior article, available at http://www.paulhastings.com/assets/publications/1933.pdf?wt.mc_ID=1933.pdf."