

## SEC Adopts Final Rule Modifying Net Worth Definition for "Accredited Investors"

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On December 21, 2011, the U.S. Securities and Exchange Commission ("SEC") adopted a final rule modifying the net worth standard for "accredited investors." Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the definition of "accredited investor" under the rules of the Securities Act of 1933 (the "Securities Act") to exclude the value of a person's primary residence for purposes of determining whether the person qualifies as an "accredited investor" on the basis of having a net worth in excess of \$1.0 million. While this change in the definition of "accredited investor" became effective upon enactment of the Dodd-Frank Act, Section 413(a) required the SEC to conform its rules under the Securities Act to the new standard. The final Rule is similar to the proposed rule promulgated in January 2011, but with two important changes relating to the inclusion in the calculation of a person's net worth of incremental debt, secured by such person's primary residence, incurred during the 60 day period prior to a sale of securities and a limited grandfathering provision for certain "follow-on" offerings.

The SEC's release adopting the revised "accredited investor" definition can be found [here](#). The final rule will become effective 60 days after its publication in the Federal Register.

### Background

The Securities Act requires all offers and sales of securities in the United States to be registered unless such offers and sales are exempt from the registration requirements of the Securities Act. Section 4(2) of the Securities Act exempts from such registration requirements offerings of securities not deemed to be a public offering, and Regulation D lays out certain safe-harbors for offerings that are deemed to comply with the exemption from registration contained in Section 4(2). Further, Rule 505 and 506 of Regulation D provide that offerings need not comply with the information requirements contained in Rule 502(b) of Regulation D if sales are made only to accredited investors (and sales to accredited investors do not count towards the 35-purchaser limits under Rules 505 and 506). Further, Section 4(5) of the Securities Act exempts certain offers and sales of securities involving offers or sales by an issuer solely to one or more accredited investors.

In general, the purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and

therefore less liquid) securities for an indefinite period and, if necessary, afford a complete loss of their investment. Since many private offerings are made only to "accredited investors," both the pool of available investors and the opportunity to invest by certain persons is impacted by whether an investor qualifies as an accredited investor.

### **Exclusion from calculation of net worth for fair market value of primary residence and certain indebtedness secured by the primary residence**

Prior to the adoption of the Dodd-Frank Act, the fair market value of a person's primary residence and the indebtedness secured by such residence were included in the calculation of net worth for purposes of determining whether such person met the \$1.0 million threshold for accredited investor status. Section 413(a) of the Dodd-Frank Act removed a person's personal residence from such calculation. The final rule excludes from the calculation of net worth any indebtedness secured by the person's primary residence, but only up to the estimated fair market value of the primary residence at the time of the sale of the securities. Thus, if the value of a person's primary residence is "underwater," it will reduce such person's net worth by the amount of indebtedness exceeding the fair market value of such person's primary residence for purposes of assessing whether or not such person is an accredited investor.

One important change made in the final rules compared to the proposed rules was the inclusion in the final rules of a requirement that indebtedness secured by a person's primary residence that exceeds the amount of indebtedness outstanding 60 days before such sale of securities reduces such person's net worth (unless such indebtedness was incurred as a result of the acquisition of such residence within such 60 day period). This change was made to prevent investors from artificially inflating their net worth by incurring incremental indebtedness securing their primary residence, thereby effectively converting their home equity into cash or other assets that would be included in the calculation of net worth. This provision was strongly supported by state securities regulators who were concerned that persons would take on debt secured by their home to qualify as an accredited investor (perhaps incentivized or urged to do so by an unscrupulous salesperson). As stated in the adopting release, the SEC believes that this change should significantly reduce the incentive for individuals to try to "game" the accredited investor net worth standard or for salespersons to attempt to induce individuals to take on incremental debt secured against their homes to facilitate a near-term investment in an offering.

### **Limited grandfathering provision included in the final rules**

Neither the Dodd-Frank Act nor the SEC's proposed rules included any transition rules, since the change in the definition of "accredited investor" became effective upon enactment of the Dodd-Frank Act. However, the final rules include a limited grandfathering provision that will permit investors who cease to qualify as "accredited investors" as a result of the changes effected in Section 413(a) of the Dodd-Frank

Act to be treated as accredited for purposes of certain subsequent or "follow-on" investments. The SEC noted in the adopting release its belief that the limited grandfathering provision strikes an appropriate balance between preserving an investors' ability to exercise previously bargained-for rights, which may otherwise be impaired by the change in the accredited investor definition, and maintaining the investor protection benefits that Section 413(a) of the Dodd-Frank Act seeks to achieve.

Under the grandfathering provision, a person's net worth will be calculated in the manner in which such net worth would have been calculated before the adoption of Section 413(a) in accordance with such person's right to purchase a security provided: (i) the right to purchase such security was held by the person on July 20, 2010 (the day before the Dodd-Frank Act was enacted), (ii) the person would have qualified as an "accredited investor" on the basis of net worth at the time such person acquired such right, and (iii) the person held securities of the same issuer, other than the right being exercised, on July 20, 2010.

#### **Future changes to the definition of who qualifies as an "accredited investor"**

Other than the changes described above, the SEC's final rule makes no additional changes to the definition of "accredited investor" and thereby to the persons who are eligible to invest in many private offerings. Further, under Section 413(b) of the Dodd-Frank Act, the SEC is prohibited from changing the definition of natural persons who qualify as an "accredited investor" until July 21, 2014 (four years after the enactment of the Dodd-Frank Act). However, Rule 413(b) also requires the SEC to review the definition of who qualifies as an "accredited investor" every four years, so additional changes may be made to the definition of "accredited investor" at some time in the future.

#### **Conclusion**

The revisions to the definition of "accredited investor" impact which persons may be able to participate in certain offerings that are exempt from the registration requirements of the Securities Act. If you have any questions regarding the new "accredited investor" definition, please contact the authors of this Client Alert or your Akerman advisor.

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