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SEC Adopts New Net Worth Standard for Accredited Investors

By Alex Frutos and Kristina M. Campbell

On December 21, 2011, the Securities and Exchange Commission ("SEC") amended its rules to exclude the value of a person's home for purposes of calculating net worth when determining whether an individual qualifies as an "accredited investor" in certain securities offerings exempt from registration under federal securities laws, including Regulation D private placement exemptions. This rule reflects the requirements of Section 413(a) of the Dodd-Frank Act and generally follows the Proposing Release issued by the SEC in January 2011 ("Proposing Release").

The "accredited investor" standards are used in determining whether certain exemptions from registration under the Securities Act of 1933 are available for private and other limited offerings. An individual may qualify as an "accredited investor" by having a net worth, alone or together with their spouse, of at least \$1 million at the time of the sale of securities. The recent amendment by the SEC excludes the value of an individual's primary residence as an asset and the debt secured by the primary residence as a liability from the net worth calculation used to determine whether that individual is an "accredited investor." However, the individual must include the amount of indebtedness secured by his or her primary residence to the extent that the indebtedness exceeds the value of the primary residence. Of note, the "value" of a primary residence is not required to be based upon a third party opinion on valuation; all that is required is an estimate of fair market value ("FMV").

Unlike the Proposing Release, the new rules attempt to address manipulation in the calculation of net worth by eliminating the ability of individuals to artificially inflate net worth by borrowing against home equity shortly before participating in an exempt securities offering. Any increase in indebtedness of an individual secured by his or her primary residence in the 60 days preceding the purchase of securities in the exempt offering must be included in the net worth calculation, even if the estimated value of the primary residence exceeds the total amount of debt secured by the primary residence. In other words, the amended rules provide for a 60-day look-back provision solely to identify and include as a liability any increase in mortgage debt during the 60-day period, without including an offset for the value of the underlying property if it is the investor's primary residence, in the calculation of net worth.

For example, if an investor had \$1,200,000 million in investment accounts, a house with a FMV of \$500,000 with a mortgage of \$600,000 and no additional assets or liabilities, they would qualify as an accredited investor under the amended Rules ($\$1,200,000 - (\$600,000 - \$500,000) = \text{net worth of } \$1,100,000$). However, an individual with \$1,100,000 in investment accounts, a house with a FMV of \$600,000 with a mortgage of \$450,000 and no additional assets or liabilities, who borrowed \$150,000 against the house thirty days prior to investment would not qualify under the amended rules

(\$1,100,000 - \$150,000 = net worth of \$950,000), as the equity in the home is not considered an asset under the new rules, but the new borrowing would be considered a liability.

Finally, it should be noted that the change in the accredited investor net worth standard took effect in July 2010, upon enactment of Section 413(a) of the Dodd-Frank Act. The SEC Rules that have been changed as a result of the December 21, 2011 amendment will go into effect 60 days after publication in the Federal Register, and no rules for transition were proposed nor set in place by the SEC. However, unlike the Proposing Release, the amended rules do include a grandfathering provision that permits the application of the former accredited investor net worth test in certain limited circumstances. With the goal of permitting prior investors to participate in follow-up rounds, the amended rules will not apply to any calculation of an individual's net worth in connection with a right to purchase securities if: (i) such right was held by the individual on July 20, 2010 (the day before enactment of the Dodd-Frank Act); (ii) the individual qualified as an accredited investor on the basis of net worth at the time they acquired such right; and (iii) the individual held securities of the same issuer, other than such right, on July 20, 2010.

We encourage companies and investors to review the **SEC Final Rule Release No. 33-9287** for the impact it may have on pending transactions. For additional information, we also encourage you to review the following:

- **JW Corporate & Securities e-Alert, Comments Due on SEC Proposed Amendments to Definition of Accredited Investor (February 11, 2011)**
- **JW Corporate & Securities e-Alert, Considering a Capital Raise: Dodd-Frank Act Makes Immediate Changes to Accredited Investor Requirements (July 23, 2010)**

If you have any questions about the amended rules or would like to speak to someone about your private offering, please contact your Jackson Walker attorney or any one of the following Jackson Walker attorneys:

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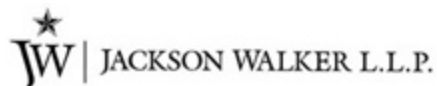
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