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SEC ADOPTS FINAL RULE AMENDING "ACCREDITED INVESTOR" DEFINITION TO CONFORM WITH DODD-FRANK ACT

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Last month, the Securities and Exchange Commission (the "SEC") adopted final amendments to the definition of "accredited investor" under the Securities Act of 1933, as amended (the "Securities Act"), to exclude the value of a person's primary residence from his or her net worth for purposes of determining whether the person is an "accredited investor" under the Securities Act rules applicable to private and other limited offerings.[1] To the extent companies have not already done so, public and private companies raising -- or planning to raise -- capital in Regulation D or other limited offerings that rely on the definition of "accredited investor" should (i) revise their subscription and disclosure documents and (ii) take appropriate additional steps to ensure that any individual investors purchasing securities based on an exemption that relies on accredited investor status meet the revised standards, since failure to comply with the new requirement could result in the loss of the company's registration exemption.

Offerings to accredited investors are provided special treatment under Regulation D, which provides safe harbor exemptions from registration under the Securities Act designed to enable companies to conduct private placements and other limited offerings of securities without registration with the SEC. Companies making offers to accredited investors are subject to less stringent requirements regarding the number of purchasers and required disclosures under certain Regulation D exemptions. The final rule also affects offerings under Section 4(5) of the Securities Act (formerly Section 4(6)), which provides an exemption from registration for certain limited offerings to accredited investors if there is no advertising or public solicitation by the issuer. Accredited investors include natural persons with individual (or joint, with the person's spouse) net worth in excess of $1,000,000.[2] Previously, an individual qualified as an accredited investor if he or she had a net worth of more than $1,000,000, including the value of his or her primary residence.

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[1] 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. Our earlier client alert on the proposed rule may be found at: http://www.wcsr.com/resources/pdfs/cs020411b.pdf.

[2] The term "accredited investor" is defined in Rule 501(a) under Regulation D, and may be found at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=20c66c74f60c4bb8392bcf9ad6fccea3&rgn=div5&view=text&node=17:2.0.1.1.12&idno=17#17:2.0.1.1.12.0.43.174. A natural person may also be treated as an accredited investor if he had individual income in excess of $200,000 (or joint income with his spouse in excess of $300,000) in each of the two most recent years and has a reasonable expectation of reaching the same income level in the current year. This income test was not changed.

This final rule reflects a requirement that became effective in connection with enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") in 2010. The DFA requires the SEC to revise the Securities Act rules to conform with the new standard. The final rule -- which is effective February 27, 2012 -- reflects the new standard, clarifies how "net worth" is calculated in determining whether a person qualifies as an accredited investor and makes certain other revisions. Specifically:

- The final rule codifies the DFA requirement that the value of a person's primary residence be excluded for purposes of determining whether the person qualifies as an accredited investor.
- Under the final rule, any indebtedness secured by a person's primary residence in excess of the property's estimated fair market value is treated as a liability.
- The final rule also provides that indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence, is not treated as a liability in determining the person's status as an accredited investor unless the borrowing occurs in the 60 days preceding the relevant offering and is not in connection with the acquisition of the primary residence. This calculation to exclude only an individual's net equity from the determination of net worth is consistent with staff guidance released after the DFA became effective.[3] The SEC included the 60-day look-back period to address concerns raised in comments to the proposed rule that individuals may artificially inflate net worth by borrowing against home equity shortly before participating in an exempt offering.
- The final rule also includes a grandfather provision so that the prior accredited investor net worth test will apply in connection with the exercise of rights to acquire securities, such as in a follow-on offering, if (i) the rights were held by the investor on July 20, 2010 (e.g., pursuant to preemptive rights or a right of first offer), (ii) the investor qualified as an accredited investor based on the net worth test at the time the rights were acquired, and (iii) the investor held securities of the same issuer (other than the rights) on July 20, 2010.

The DFA requires that the revised net worth standard remain in place until July 21, 2014, four years after enactment of the DFA. Beginning in 2014 and every four years thereafter, the SEC will be required to review the definition of "accredited investor" in its entirety and make appropriate changes.

Contact Information

We will continue to monitor SEC rulemaking concerning the "accredited investor" standard. If you have any questions regarding the final rule, please contact Shandra N. Stout (http://www.wcsr.com/ShandraStout), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: http://www.wcsr.com/profSearch?team=corporateandsecurities.

[3] SEC Staff Compliance and Disclosure Interpretation ("C&DI") 179.01 and C&DI 255.47 may be found at: http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.