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A legal update from Dechert LLP

SEC Acknowledges Exclusion of the Value of a Principal Residence in Determining “Accredited Investor” Status

Regulation D¹ under the Securities Act of 1933, as amended (the “Securities Act”), sets forth a safe harbor from the registration requirement of the Securities Act for certain private placements of securities, including those to “accredited investors.” The Dodd-Frank Wall Street Reform and Consumer Protection Act² (the “Dodd-Frank Act”) amended the standard for accredited investor status on July 21, 2010, to exclude the value of a natural person’s primary residence in determining whether the individual net worth of that person (or joint net worth with his or her spouse) exceeds the \$1 million net worth test. Recently the Securities and Exchange Commission (the “SEC”) released a final rule conforming to the Dodd-Frank Act requirement that will be effective on February 27, 2012, fully 586 days after Congress changed the net worth test in the definition of accredited investor.³

Under the amended definition as required by the Dodd-Frank Act, the value of an individual’s primary residence may not be included as an asset of such individual in calculating his or her net worth for purposes of determining accredited investor status. The rule also excludes the value of any mortgage or other debt

secured by an individual’s primary residence as a liability to be deducted from such investor’s net worth, provided that the debt does not exceed the fair market value of the primary residence. To the extent the debt exceeds the fair market value of the investor’s primary residence, the excess must be included as a liability in calculating the individual’s net worth.

The amended net worth definition also addresses attempts to circumvent its requirements by specifically requiring that any mortgage or other debt secured by an individual’s primary residence and incurred within 60 days prior to the determination of accredited investor status under Regulation D, other than a loan used to purchase a primary residence, must be deducted from the investor’s net worth regardless of whether the total mortgage debt exceeds the fair market value of the residence.

The time at which accredited investor status is determined is not affected by the amended rule and remains the time of the sale of securities under Regulation D. The amended definition does not alter or expand the requirements for calculating the fair market value of an individual’s primary residence, so an estimate of fair market value continues to suffice.

Because the requirement to exclude the value of an investor’s primary residence from calculation of net worth already took effect on July 21, 2010, a very limited grandfathering

¹ 17 C.F.R. §230.501-§230.508 (2011).

² See Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

³ SEC Release 33-9287 (Dec. 21, 2011), available at: <http://www.sec.gov/rules/final/2011/33-9287.pdf>.

provision applies to rights to purchase additional securities of an issuer. The value of an individual's primary residence may be included when calculating net worth only if he or she meets each of the following three requirements:

- The individual must have held the right to purchase securities on July 20, 2010.
- The individual must have qualified as an accredited investor at the time he or she acquired the right to purchase such securities.
- On July 20, 2010, the individual must have already owned securities of the issuer other than the right to purchase securities in question.

If they have not already done so, we recommend that companies contemplating a private placement to accredited investors revise their subscription agreements and other investor questionnaires to state clearly the requirements for computation of investor net worth. We also recommend that companies consult with counsel to discuss any private placement since July 21, 2010 that may have included investors who did not comply with the appropriate accredited investor standard. Furthermore, companies should ensure that potential investors are aware that net worth must be

reduced by the amount of any indebtedness on a primary residence (other than indebtedness incurred in connection with the purchase of such residence) incurred within the 60 days prior to a sale of securities under Regulation D.

Section 413(b) of the Dodd-Frank Act requires the SEC to review the definition of accredited investor as it applies to natural persons every four years, with the first review to take place in July 2014. Section 415 of the Dodd-Frank Act mandates the Comptroller General of the SEC to study appropriate thresholds for accredited investor status and produce a report in 2013. The SEC has indicated that the Comptroller General's report and the mandated agency review are likely to result in changes to the definition of accredited investor as it applies to a natural person.⁴

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⁴ *Id.*, pp. 4-5.

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