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Regulatory Update: SEC Adopts Final Rules Defining "Accredited Investor" Consistent with Dodd-Frank

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Just before 2011 year-end, the SEC adopted final rules first proposed in January 2011 to exclude the value of an investor's home when determining if an investor meets the net worth test for an accredited investor. A person's status as an accredited investor affects eligibility, sophistication and information requirements for certain unregistered securities offerings. The final rules differ from the proposed rules by addressing home equity indebtedness incurred in the 60 days prior to an offering, and by grandfathering securities purchase rights held prior to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

This post updates earlier posts entitled "Legal Update: Dodd-Frank Redefines 'Accredited Investor'" posted on July 23, 2010, "Legal Update: Dodd-Frank Redefines 'Accredited Investor'" and the SEC Provides New Guidance" posted on September 3, 2010, and "SEC Proposes Amendments To Reflect Dodd-Frank's Definition Of Accredited Investor" posted on February 7, 2011.

Background

Certain private and limited offerings of securities can be exempt from registration and disclosure requirements under the Securities Act of 1933 and state "blue sky" laws if such offerings are made only to "accredited investors," as such term is defined in Rule 215 of the Securities Act of 1933 and Rule 501 of Regulation D promulgated thereunder. Prior to the enactment of Dodd-Frank on July 21, 2010, the definition of an accredited investor included a natural person with a net worth of at least $1 million, either individually or jointly with such investor's spouse. The value of such investor's primary residence was included as an asset in the calculation of his or her net worth for purposes of determining accredited investor status and the indebtedness secured by the primary residence was treated as a liability for such purposes. Effective immediately on enactment, Section 413(a) of Dodd-Frank amended the definition of accredited investor to exclude the value of an investor's primary residence from the $1 million net worth calculation. As such, the amended definition of accredited investor specifically excluded the entire value of an investor's primary residence from the investor's assets in the net worth calculation, including any positive equity such investor may have in the primary residence, but did not specify whether indebtedness secured by the primary residence would still be treated as a liability.

The SEC released guidance on July 23, 2010 that clarified the treatment of indebtedness secured by an investor's primary residence for the purposes of the net worth calculation used to determine accredited investor status. The guidance stated that, pending forthcoming SEC rule changes, the amount of indebtedness secured by an investor's primary residence may also be excluded along with the value of an investor's primary residence for the purposes of determining the investor's net worth. However, the guidance went on to state that if the indebtedness secured by the residence exceeds the estimated fair market value of the residence, such excess amount should be considered a liability and deducted from an investor's net worth for the purposes of determining accredited investor status. On January 25, 2011, the SEC proposed amendments to its rules to reflect its July 2010 guidance on the treatment of indebtedness secured by the residence in the net worth calculation.

What changes now?

On December 21, 2011, the SEC adopted final rules to amend to the accredited investor standards in its rules under the Securities Act of 1933 to implement the requirements of Section 413(a) of Dodd-Frank. Under the new definition, the value of a person's primary residence is not treated as an asset for purposes of determining whether the person qualifies as an accredited investor on the basis of having a net worth in excess of $1 million. Correspondingly, borrowing secured by such primary residence, up to the estimated fair market value of the primary residence at the time of the calculation, is not treated as a liability in the net worth calculation. However, any debt secured by a primary residence in excess of the estimated fair market value of the property at the time of the calculation is treated as a liability in the net worth calculation.

The final rules adopted by the SEC differ from the January 2011 proposed rules in that they include a provision addressing the treatment of incremental debt secured by the primary residence that is incurred in the 60 days before the sale of securities to the investor. If the investor borrows against the primary residence in the 60 days preceding the purchase of securities in the exempt offering, and the borrowing is not in connection with the acquisition of the primary residence, the debt will be treated as a liability in the net worth calculation.

The final rules also add a grandfathering provision which permits the application of the former accredited investor net worth test in certain limited circumstances. The pre-Dodd-Frank definition of an accredited investor may be used to determine an investor's net worth for a purchase of securities if (i) the right to purchase such securities was held by the investor on July 20, 2010, (ii) the investor qualified as an accredited investor on the basis of net worth at the time the investor acquired such right, and (iii) the investor held securities of the same issuer on July 20, 2010.

The December 2011 amendments will go into effect on February 27, 2012.

What Happens Next?

Pursuant to the Dodd-Frank Act's requirements, the SEC must review the accredited investor definition in its entirety every four years, commencing in 2014,. The SEC is empowered to make additional modifications to the definition based on such future reviews.

What Should You Do Now?

Issuers should make the appropriate adjustments to their subscription documents and investor questionnaires to reflect the amended definition of accredited investor. Subscription documents and investor questionnaires should cover incremental debt secured by a primary residence incurred in the 60 days before the sale of securities to an investor, and where applicable, pre-Dodd-Frank accredited investor status.

What if you have questions?

For any questions or more information on these or any related matters, please contact any attorney in the firm's corporate practice group. A list of such attorneys can be found by clicking " Lawyers" on this page.

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