

SEC Adopts Net Worth Standard for Accredited Investors

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Introduction

On December 21, 2011, the U.S. Securities and Exchange Commission (the “SEC”) adopted a final rule under the Securities Act of 1933 (the “Securities Act”) that amends the net worth standard used in the definition of an “accredited investor.” Qualification as an accredited investor enables individuals to take part in certain non-public and limited securities offerings. This rule change conforms the net worth standard under the Securities Act to the standard under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which has been effective since July 21, 2010. This note briefly describes the key features and implications of the new rule.

The Rule

Prior to the rule change, natural persons (individually or jointly with their spouses) qualified as accredited investors if their net worth exceeded \$1MM.¹ Under the newly adopted rule, the equity value of a person’s primary residence is excluded from the calculation of net worth.² Specifically, the fair market value of a primary residence is not included as an asset in the net worth calculation, nor is debt secured by the residence included as a liability.³

Exceptions

The new rule does provide for certain exceptions. First, any indebtedness secured by a primary residence that was incurred during the sixty-day period prior to the relevant sale of securities is included as a liability in the calculation of net worth—except if such indebtedness resulted from the acquisition of the primary residence⁴ (i.e., the indebtedness was a mortgage used to purchase the residence). Second, the excess of indebtedness secured by a primary residence over the fair market value of the primary residence is included as a liability, regardless of when such excess indebtedness was incurred or whether it is nonrecourse.⁵ In a release announcing the adoption of the final rule, the SEC explained that the above-described exceptions were adopted to prevent individuals from taking out home-equity loans for the purpose of acquiring other assets and thereby inflating their net worth.⁶

A third exception provides relief for persons who had previously acquired a right, such as an option or warrant, to acquire securities, which right they now can no longer exercise by virtue of not qualifying as an accredited investor under the new rule. This exception provides that, in connection with the exercise of such right, the value of a person’s primary residence will not be excluded from the net worth calculation if: (a) such right was held by the person on July 20, 2010, (b) the person qualified as an accredited investor on the basis of net worth at the time the

person acquired such right and (c) the person held securities of the same issuer, other than such right, on July 20, 2010.⁷

Conclusion

This new rule represents a major change for individual investors. Home equity often constitutes the single largest asset for such investors. Accordingly, many individual investors will be unable to qualify for participation in private placements and other limited offerings of securities. The authors of the Dodd-Frank Act were of the view that the perceived illiquidity and risk profile of the securities sold in such placements and offerings are not suitable for certain individual investors. Whether the benefits of protecting these investors outweigh the costs remains to be seen.

¹ Former 17 CFR 230.215(e) (limited offerings made exclusively to accredited investors) & 230.501(a)(5) ("Reg D" offerings).

² 17 CFR 230.215(e)(1) & 230.501(a)(5)(i).

³ *Id.*

⁴ 17 CFR 230.215(e)(1)(ii) & 230.501(a)(5)(i)(B).

⁵ 17 CFR 230.215(e)(1)(iii) & 230.501(a)(5)(i)(C); SEC Release No. 33-9287, at 13.

⁶ SEC Release No. 33-9287, at 11, 14.

⁷ 17 CFR 230.215(e)(2) & 230.501(a)(5)(ii).

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