SEC Adopts Revised Net Worth Standard for Accredited Investors

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The Securities and Exchange Commission (SEC) recently adopted amendments to the net worth standard for accredited investors set forth in Rules 215 and 501 under the Securities Act of 1933 (Securities Act). Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the SEC to revise the definition of "accredited investor" in its rules under the Securities Act to exclude the value of a natural person's primary residence when determining whether that person has a net worth in excess of $1 million. The change to the net worth standard was effective upon the enactment of Dodd-Frank on July 21, 2010, but the SEC was required to amend its Securities Act rules to conform to the new standard. The SEC's rule amendments will be effective on February 27, 2012.

Revised Net Worth Standard

The SEC's accredited investor definitions set forth in Securities Act Rules 215 and 501 include any person who comes within (or who the issuer reasonably believes comes within) any of eight listed categories at the time of the sale of securities to that person. One of the categories requires any natural person, individually or jointly with that person's spouse, to have a net worth in excess of $1 million. Prior to the adoption of Dodd-Frank Section 413(a), the $1 million net worth standard permitted the net worth calculation to include the value of the person's primary residence. Dodd-Frank Section 413(a) requires that the value of the person's primary residence be excluded from the net worth calculation beginning upon the enactment of Dodd-Frank on July 21, 2010.

The SEC's revised net worth standard provides that when a person (individually or jointly with their spouse) calculates whether he or she has a net worth in excess of $1 million:

- the person's primary residence will not be counted as an asset, thereby excluding any positive equity the person may have in the residence; and
- debt secured by the person's primary residence will not be counted as a liability, except for:
  - the amount of any such debt in excess of the estimated fair market value of the primary residence at the time of the sale of securities (*e.g.*, an underwater mortgage), whether or not the lender can seek repayment from other assets in default; and
  - the amount of any such debt incurred within 60 days prior to the sale of securities (*e.g.*, home equity loans), unless incurred to acquire the primary residence.

In a change from Dodd-Frank Section 413(a) and the SEC's proposed amendments, the SEC added the requirement to count as a liability any debt secured by the primary residence that was incurred within 60 days prior to the sale of securities. The SEC added this requirement to mitigate potential incentives for individuals to increase their net worth by incurring mortgage debt and effectively converting their home equity, which is excluded from the net worth calculation under the amendments, into cash or other assets in order to qualify as an accredited investor. This requirement applies even if the estimated fair market value of the primary residence exceeds the aggregate amount of debt secured by the residence.

The amendments did not include definitions of "net worth" or "primary residence." However, the SEC indicated in the adopting release its belief that (1) the commonly understood meaning of "net worth" is "the difference between the value of a person's assets and the value of the person's liabilities" and (2) the commonly understood meaning of "primary residence" is "the home where a person lives most of the time."

Limited Grandfathering Provision

In a change from Dodd-Frank Section 413(a) and the SEC's proposed amendments, the revised net worth standard contains a limited grandfathering provision under which the net worth standard in place prior to the enactment of Dodd-Frank Section 413(a) will apply to the purchase of securities pursuant to a right to purchase securities so long as:

- the purchase right was held by a person on July 20, 2010, the day prior to enactment of Dodd-Frank Section 413(a);
- the person qualified as an accredited investor on the basis of net worth at the time the purchase right was acquired; and
- the person held securities of the same issuer, other than the purchase right, on July 20, 2010.

The grandfathering provision applies to the exercise of statutory rights (*e.g.*, state law preemptive rights), rights arising under an issuer's constituent documents and contractual rights, including rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible instrument, rights of first offer or first refusal and contractual preemptive rights.

Implications of Revised Net Worth Standard

The revised net worth standard will impact issuers (including start-up companies, venture capital funds, private equity funds, hedge funds and real estate funds) that rely on the net worth standard to raise capital from individual investors in private placements of securities pursuant to Regulation D under the Securities Act or Section 4(5) of the Securities Act. In theory, the revised standard could result in a lower pool of possible accredited investor candidates and, therefore, make less private capital available for issuers. The SEC noted that there is no available data tracking Regulation D investment by household, so it could not develop quantitative estimates of the economic impact of eliminating from the pool of accredited investors the households that no longer qualify based on the new net worth standard or of providing exemptive or other relief from the new standard, which would keep such households in the accredited investor pool. To the extent that the revised net worth standard reduces the pool of accredited investors, the revised standard could force issuers to seek to (1) raise private capital from non-accredited investors, which would likely require the issuers to change their offering processes, including changes to the information provided to investors and the number of permitted investors, or (2) rely on a securities registration exemption other than Regulation D or Section 4(5).

Action Items

Issuers, including funds, that rely on the net worth standard to raise capital from individual investors in private placements should review their offering documents, subscription agreements and investor questionnaires, as well as the terms of any outstanding rights to purchase securities that allow exercise or conversion by accredited investors, to determine whether any changes are necessary in response to the revised net worth standard. As the revised net worth standard includes revisions to the SEC's proposed amendments, issuers should conduct this review even if the documents were previously updated in response to the enactment of Dodd-Frank Section 413(a) and the issuance of the SEC's proposed amendments.

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