

SEC Adopts Revised Accredited Investor Definition

The Securities and Exchange Commission (the “SEC”) recently adopted amendments to the “accredited investor” standards in rules under the Securities Act of 1933 (“Securities Act”). These changes implement Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). That provision requires that the SEC adjust any net worth standard for an accredited investor in the rules under the Securities Act so that the individual net worth of any natural person (or joint net worth with a spouse) is more than \$1,000,000, excluding the value of the person’s primary residence. That change to the net worth standard was effective upon enactment of the Dodd-Frank Act and the amendments primarily relate to the accredited investor definition in Securities Act Rule 215 and 501(a) as well as technical amendments to Form D. The final amendments clarify treatment of mortgage debt and provide a limited grandfathering provisions. The SEC release adopting the amendments is available at <http://sec.gov/rules/final/2011/33-9287.pdf>.

Background

Prior to the current amendments, Securities Act Rules 501(a) and 215 defined “accredited investor” to include, among other things, any natural person:

- whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000; and
- who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The Dodd-Frank Act required that the SEC adopt rules to revise this definition as it relates to natural persons to exclude the value of a person’s primary residence in meeting the \$1 million net worth threshold. The income requirement of the second provision remains unchanged by the Dodd-Frank Act and the current amendments. Although the Dodd-Frank Act left the task of setting a final net worth standard to the SEC, the primary residence exclusion was effective immediately upon enactment of the Dodd-Frank Act.

Changes to the Accredited Investor Definition

The net worth standard of the “accredited investor” definition in Rules 215(e) and 501(a)(5) under the Securities Act has been amended to include any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000 except that the person’s primary residence may not be included as an asset for purposes of calculating net worth under this rule. Additionally, the final amendments include (1) provisions addressing the treatment of debt secured by the primary residence for purposes of the accredited investor standard and (2) a grandfathering provision that permits application of the former accredited investor net worth test in certain limited circumstances as described further below.

Definition of “Primary Residence”

The SEC did not define “primary residence” in its original rule proposal. After reviewing comments to the proposed amendment, the SEC confirmed their decision to leave “primary residence” undefined for purposes of these rules. The SEC indicated that issuers and investors should be able to use the commonly understood meaning of primary residence, which is the home where a person lives most of the time. The SEC has also suggested that where complex or unusual circumstances exist, issuers and investors may look to further guidance from other sources including income tax rules and rules applying to acquiring mortgage loans.

Treatment of Mortgage Debt

Under the final amendments, net worth will be calculated excluding any positive equity an investor might have in their primary residence. Indebtedness that is secured by a person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, is generally not included as a liability. However, indebtedness that is secured by a person's primary residence in excess of the estimated fair market value of the primary residence at the time of sale of securities is included as a liability. The amendments effectively exclude the value of the primary residence from net worth without reducing the net worth by more than the amount that the residence contributed to the net worth calculation. However, to the extent a homeowner is "underwater" on their mortgage, that amount will be used to reduce a person's net worth for purposes of the accredited investor standard.

Additionally, under the final rules if an amount of debt secured by a primary residence at the time of sale of securities exceeds the amount outstanding 60 days before such time (other than as a result of the acquisition of the primary residence) the amount of such excess is included as a liability for purposes of calculating net worth for the accredited investor standard. This means that if a homeowner increases the amount of debt on a primary residence in the 60 days prior to purchase of securities where they are relying on the accredited investor net worth standard, the amount of any such increase in debt must be used to reduce their net worth calculation.

Grandfathering Provision

The original SEC accredited investor proposal did not include a transition rule to the new standard. However, the final amendments adopted by the SEC contain a provision providing limited grandfathering in connection with investors' exercise of certain pre-existing rights to acquire securities. The final amendments provide that the exclusion of primary residence as part of the calculation of net worth along with the provisions related to indebtedness secured by a primary residence do not apply to any calculation of a person's net worth made in connection with a purchase of securities in accordance with a right to purchase such securities, provided that (1) such right was held by the person on July 20, 2010, (2) the person qualified as an accredited investor on the basis of net worth at the time the person acquired such right and (3) the person held

securities of the same issuer, other than such right, on July 20, 2010. For example, if an investor who qualified as accredited based on net worth at the time of their original investment owned common stock of an issuer on July 20, 2010, and on that date had pre-emptive rights to acquire additional common stock of that issuer, then when the issuer makes an offering of common stock that triggers the pre-emptive rights, the investor's net worth will be calculated as it was before enactment of the Dodd-Frank Act.

Ongoing Review of the Definition of Accredited Investor

The Dodd-Frank Act specifically authorizes the SEC to undertake a review of the accredited investor definition as it applies to natural persons and requires the SEC to review the definition in its entirety every four years, beginning July 21, 2014. The SEC is also authorized to engage in rulemaking to make adjustments to the definition after each such review. While the proposed amendments only make revisions that are specifically required by the Dodd-Frank Act at this time, the SEC may consider other changes in the future.

Accredited Investor Study

The Dodd-Frank Act also requires the Comptroller General to conduct a study on accredited investors examining the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. The study is due July 21, 2013. The SEC expects that the results of this study will inform any future rulemaking in this area that takes place after the study is completed.

What Should I Do Now?

These amendments to the accredited investor standard become effective 60 days after publication in the Federal Register, which should occur in the next few days. That means that the new provisions should be effective near the end of February 2012 or the beginning of March 2012. Issuers relying on the definition of "accredited investor" in order to effect sales to accredited investor should immediately review their disclosure and subscription documents and revise those documents as necessary to reflect these changes.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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