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SEC Amends Accredited Investor Net Worth Standard To Conform To Dodd-Frank

By Vincent A. Vietti and Lauren W. Taylor

On December 21, 2011, the U.S. Securities and Exchange Commission (SEC) adopted final rules that exclude the value of a person's home from the net worth calculations used to determine if such person is an "accredited investor" under Regulation D under the Securities Act of 1933, as amended. The rule becomes effective on February 27, 2012 and represents the final step in conforming SEC rules with the net worth standard imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The new rule makes no change in existing law but does provide clarity and includes an exception for certain "follow on" investments or purchase rights that existed on July 20, 2010, the day before the effective date of Dodd-Frank.

Final Rule

SEC rules permit certain private and limited offerings to be made without registration, and without requiring specified disclosures, if sales are made only to "accredited investors." One way individuals may qualify as "accredited investors" is by having a net worth, alone or together with their spouse, of at least $1 million. The final rule provides that in calculating an individual's net worth:

1. The person's primary residence shall not be included as an asset;
2. Indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability; and
3. Indebtedness secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability.

Importantly, the final rule provides that indebtedness secured by a primary residence that is incurred during the 60 days prior to the sale of the securities at issue must be included as a liability, unless such indebtedness was incurred in connection with the acquisition of the primary residence. This provision applies even if the total indebtedness secured by the individual's primary residence is <u>less than</u> the estimated fair market value of the primary residence. The SEC noted that this provision is intended to reduce incentives to increase the debt secured against one's residence for the purpose of making investments in securities or increasing one's net worth in order to qualify as an accredited investor by converting home equity (which is excluded from the net worth calculation) into cash or other assets which are included in calculating net worth.

Grandfather Provision

In addition, the SEC agreed to "grandfather" individuals who previously satisfied the definition of accredited investor to permit them to qualify for certain follow-on investments under the old net worth standard. Specifically, the revised net worth standard will not apply to the calculation of a person's net worth in connection with a purchase of securities, provided that:

1. The right to purchase such securities was held by the individual on July 20, 2010;
2. The individual qualified as an accredited investor on the basis of net worth at the time the individual acquired such right; and
3. The individual held securities of the same issuer, other than such right, on July 20, 2010.

In these circumstances, such an investor will only be required to satisfy the net worth standard in place prior to Dodd-Frank. The forgoing would generally apply to capital calls, pre-emptive rights and the exercise of derivative instruments, such as options, warrants and convertibles.

What's Next?

Beginning in 2014 and every four years thereafter, Dodd-Frank requires the SEC

to review the "accredited investor" definition in its entirety and to engage in further rulemaking to the extent it deems appropriate. Dodd-Frank also requires the Comptroller General of the United States to conduct a study and issue a report within three years regarding the appropriate criteria for determining accredited investor status. The SEC expects to consider the report in connection with its review and at this time, is not proposing or adopting any other revisions to the "accredited investor" standards.

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For more information, please contact the following members of the Fox Rothschild Securities Practice:

Jeffrey H. Nicholas
215.918.3639
jnicholas@foxrothschild.com

Vincent A. Vietti
609.896.4571
vvietti@foxrothschild.com

Stephen M. Cohen
215.299.2744
smcohen@foxrothschild.com

Ernest E. Badway
973.994.7530
ebadway@foxrothschild.com

Fox Rothschild LLP
ATTORNEYS AT LAW

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