



Alerts

SEC Revises Net Worth Standard for Accredited Investors

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Corporate / Financial Institutions Alert

Summary

U.S. Securities and Exchange Commission (SEC) Rules 505 and 506 of Regulation D and Rule 215 permit certain private offerings to be made without registration, and without requiring specified disclosures, if sales are made only to “accredited investors.” An individual may qualify as an “accredited investor” by having a net worth, alone or together with his or her spouse, of at least \$1 million. Under the SEC rules previously in effect, the value of an investor’s primary residence was included when making the net worth calculation.

Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires that the value of a person’s primary residence be excluded from the net worth calculation when determining whether a person is an “accredited investor.” This Dodd-Frank provision became effective on July 11, 2011, the day the statute was enacted.

On December 21, 2011, the SEC amended its rules to exclude the value of a person’s primary residence from net worth calculations used to determine whether an individual is an “accredited investor.” The amended net worth standard will take effect on February 27, 2012.

Net Worth Standard for Accredited Investors

Overview of the Amended Rules

Section 413(a) of Dodd-Frank directs the SEC to adjust the accredited investor net worth standard so that to qualify an investor would have to have a net worth of “more than \$1,000,000 . . . excluding the value of the primary residence.”

Rule 501 of Regulation D defines the term “accredited investor” for purposes of nonpublic and limited offerings under Rules 505 and 506 of Regulation D. The definition of “accredited investor” includes persons who come within any of eight listed categories, or who the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that person. The \$1 million individual net worth standard is one such category.

Under Regulation D, issuers are subject to fewer regulatory requirements when the purchasers of their securities are accredited investors. In order to comply with the exemptions afforded by Rule 505 and Rule 506, there may be no more than 35 purchasers of securities in the offering. However, accredited investors

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are not counted as purchasers for that purpose (see Rule 501(e)); consequently, an unlimited number of accredited investors may participate in an offering under Rule 505 or 506. If non-accredited investors are allowed to participate in a Rule 505 or 506 offering, an issuer must comply with specific information requirements. Click here for a [discussion of Rules 505 and 506 of Regulation D](#).

Rule 215 defines the term “accredited investor” under Section 2(a)(15) of the Securities Act of 1933 (Securities Act). Section 2(a)(15) and Rule 215 set the standards for accredited investor status under Section 4(5) of the Securities Act, which permits offerings of up to \$5 million, subject to certain conditions, including that the offering is solely made to accredited investors. Rule 215(e) contains the \$1 million net worth test and it has also been revised.

New Rules

As amended, the new individual net worth standard in the accredited investor definition is:

Any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000.

(1) Except as provided in paragraph (2) of this section, for purposes of calculating net worth under this paragraph:

- (i) The person’s primary residence shall not be included as an asset;
- (ii) Indebtedness that is 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 (except that if the amount of such indebtedness outstanding at the time of the 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 shall be included as a liability); and
- (iii) Indebtedness that is 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.

(2) Paragraph (1) of this section will 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:

- (i) such right was held by the person on July 10, 2010 (the day before Dodd-Frank was enacted);
- (ii) the person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and
- (iii) the person held securities of the same issuer, other than such right, on July 20, 2010.

All tests under the accredited investor definition are measured “at the time of the sale of securities to that person.” Thus, if a person loses his or her status after receiving the offering materials but before buying the securities, that person is not an accredited investor.

Calculating the Value of the Primary Residence

Under the new definition, an individual’s net worth will be calculated excluding any positive equity he or she may have in his or her primary residence.

Under the old definition, an investor who had a primary residence with an estimated fair market value of \$1.2 million and a mortgage loan of \$800,000 and \$1.6 million in other assets would have a net worth of \$2 million. Under the new definition, the value of the primary residence would be excluded, thereby reducing the investor’s net worth by \$400,000, the equity value of the primary residence, leaving the investor with a net worth of \$1.6 million.

Appraisal. The rules as previously applied did not require a third-party opinion on valuation, either for the primary residence or for any other assets or liabilities. The new rules do not change this. All that is required is an estimate of fair market value. See, e.g., Release No. 33-6455 (March 3, 1983) at Question 21 (confirming that, under the net worth



standard in effect at the time, “the estimated fair market value” of a primary residence could be considered as an asset) and Question 45 (individual statement of net worth reflects estimated value of assets and liabilities).

Underwater Property. If the amount of mortgage debt exceeds the value of the primary residence, the excess of the amount of the mortgage over the fair market value of the primary residence is included as a liability. Mortgage debt in excess of the value of the primary residence cannot be excluded from the net worth calculation even if the borrower would not be subject to personal liability by reason of contractual terms or state anti-deficiency statutes or similar laws. Although this indebtedness may not be legally collectible, it is considered a liability for purposes of determining accredited investor status on the basis of net worth, regardless of whether the lender can seek repayment from other assets in default.

Increases in Mortgage Debt in the 60 Days Before Sale of Securities

The SEC was concerned that investors might artificially inflate their net worth by incurring incremental indebtedness secured by their primary residence, thereby effectively converting their home equity—which is excluded from the net worth calculation under the recently adopted rules—into cash or other assets that would be included in the net worth calculation. For example, an investor with \$400,000 of equity in his or her primary residence could boost his or her net worth by borrowing an additional \$100,000 against the residence and investing those funds in other assets that would count as assets for the \$1 million net worth test.

The final rule provides that net worth will be calculated only once, at the time of sale of securities (the same time as under current rules). If incremental debt secured by the primary residence is incurred in the 60 days before the sale of securities, the investor’s net worth will be reduced by the amount of the incremental debt. The only additional calculation required by the 60-day look-back provision is to identify any increase in mortgage debt over the 60-day period preceding the purchase of securities.

The rule provides an exception to the 60-day look-back provision for increases in debt secured by a primary residence where the debt results from the acquisition of the primary residence. The 60-day look-back provision is not intended to address debt secured by a primary residence that is incurred in connection with the acquisition of a primary residence within the 60-day period.

Transition Rules

The change in the accredited investor net worth standard took effect on July 11, 2010, upon enactment of Section 413(a) of Dodd-Frank. No grandfathering or transition provisions were included in Section 413(a), so market participants have been operating under the new standard for more than year.

Generally, the SEC did not adopt grandfathering or other transition provisions. In cases where securities would be purchased based on an investment decision made before enactment of Dodd-Frank (for example, a capital call that is not subject to conditions under the investor’s control, under an agreement entered into before enactment of Dodd-Frank), accredited investor status would have been determined at the time of the investment decision. Therefore, the investor’s net worth status would not have to be revisited.

The former accredited investor net worth test may be used to purchases of securities in accordance with a right to purchase such securities held by the investor, so long as (1) the right was held by a person on July 10, 2010, the day before the enactment of Dodd-Frank; (2) the person qualified as an accredited investor on the basis of net worth at the time the right was acquired; and (3) the person held securities of the same issuer, other than the right, on July 10, 2010. The grandfathering provision applies to the exercise of statutory rights, such as preemptive rights arising under state law; rights arising under an entity’s constituent documents; and contractual rights, such as 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.

For example, if an investor who qualified as accredited based on net worth at the time of her original investment owned common stock of an issuer on July 10, 2010, and on that date had preemptive rights to acquire additional common stock of that issuer, then when the issuer makes an offering of common stock that triggers the preemptive rights, the investor’s net worth will be calculated as it was before enactment of Dodd-Frank. Similarly, if the same investor owned Series A



preferred stock of an issuer on July 10, 2010, and on that date had a right of first offer to purchase any equity securities offered by the issuer in a future sale, and the issuer proposed to sell Series B preferred stock at a future date, then the investor's net worth would be calculated as it was before enactment of Dodd-Frank for purposes of exercising the right of first offer to purchase Series B preferred stock from the issuer. The provision is limited to persons who qualified as accredited investors on the basis of net worth at the time the relevant rights were originally acquired, and who held securities of the issuer other than the rights on July 10, 2010.

For further information, please contact [Tim M. Sullivan](#) or your regular [Hinshaw attorney](#).

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