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CLIENT UPDATE **DECEMBER 2011**

SEC ADOPTS DODD-FRANK NET WORTH STANDARD FOR ACCREDITED INVESTORS

The Securities and Exchange Commission ("SEC") has revised the net worth definition of "accredited investor" that qualifies an individual for private investment activity in unregistered securities offerings. An individual whose primary residence makes up a large part of his or her net worth may no longer qualify as an accredited investor.

On December 21, 2011, the SEC adopted rule amendments under the Securities Act of 1933 (the "Securities Act") to conform the definition of accredited investor to the requirements of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] These amendments adjust the "accredited investor" definition in the rules promulgated under the Securities Act to exclude the net value of the primary residence from calculation of a person's net worth. The change to the definition became effective upon the passage of Dodd-Frank on July 21, 2010; by this final rule release, the SEC has updated the SEC rules to conform to Dodd-Frank. Section 413(b) of Dodd-Frank also requires the SEC to review and adjust the definition of "accredited investor" every four years, but the SEC has not yet proposed or adopted rules to do so. These final rules will go into effect on February 27, 2012.

ACCREDITED INVESTORS UNDER THE SECURITIES ACT

The accredited investor definitions in Rules 501 and 215 under the Securities Act now reflect the revised net worth test that excludes the value of a primary residence. Accredited investor status is crucial to Rules 505 and 506 of Regulation D of the Securities Act, two safe harbor provisions that ensure that certain limited offerings and private placements are exempt from the registration requirements of Section 5 of the Securities Act. Accredited investors do not count toward the limitations on the number of purchasers under Rule 505 or 506, and are not subject to the sophistication requirement of Rule 506. Offers to accredited investors do not require the specific disclosures otherwise mandated. Issuers frequently limit their private placements solely to accredited investors so as to simplify compliance with these rules.

Under the new rules, an individual qualifies as an accredited investor if that person has either:

(1) an individual net worth, or joint net worth with that person's spouse, exceeding $1,000,000, but not including the value of the primary residence as described below; or

(2) an individual income in excess of $200,000, or joint income in excess of $300,000, in each of the two most recent years, and a reasonable expectation of reaching the same income level in the current year.

AMENDED NET WORTH CALCULATION

PRIMARY RESIDENCE NOW EXCLUDED FROM NET WORTH CALCULATION

Under the new rules, the primary residence is excluded as an asset for purposes of the net worth calculation. Mortgage debt secured by the primary residence is also excluded as a liability up to the estimated fair market value of the residence. As a result, any positive equity is

[1] Net Worth Standard for Accredited Investors, Release No. 33-9287 (December 21, 2011), available at http://www.sec.gov/rules/final/2011/33-9287.pdf.

excluded from the calculation of net worth, but any negative equity will still reduce net worth.

Recently Increased Indebtedness Reduces Net Worth

The rule also includes a provision to prevent artificial inflation of net worth through home equity borrowing in connection with a transaction. Any increase in mortgage indebtedness incurred within 60 days of a transaction will count as a liability against the individual's net worth, unless the debt was the result of acquiring a primary residence. The SEC sought to make it more difficult for individuals or unscrupulous salespeople to encourage "gaming" the amended accredited investor net worth definition.

Transition Rules For Follow-On Investments

Transition rules allow some investors who no longer qualify as accredited under the amended rules to participate in follow-on investments if they still qualify under the previous definition. The prior accredited investor test applies to a follow-on investment by an investor who (1) acquired a right to purchase prior to July 20, 2010; (2) qualified as an accredited investor at the time the right was acquired; and (3) held securities of the issuer, other than the right, at the time the right was acquired. Exercising pre-emptive rights to avoid dilution of an existing investment would qualify for the transition provision. Furthermore, if an investment decision that included a binding obligation for later investment was made prior to Dodd-Frank, the investor's accredited status was determined at the time of the original investment decision, and carries over to the subsequent obligated investment.

Future Review of the Accredited Investor Definition

Section 413 of Dodd-Frank also requires the SEC to review and adjust the definition of "accredited investor" every four years. The SEC has not yet proposed or adopted rules to effect this review process. The Commission is waiting on the results of a "Study and Report on Accredited Investors" from the Comptroller General, due three years after Dodd-Frank's enactment.

Additional Information

For more information regarding the SEC's new accredited investor rules, please get in touch with your Tucker Ellis & West LLP contact or one of the following attorneys:

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