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Legal Update
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"Net Worth" Standard for Accredited Investors Further Amended by US Securities and Exchange Commission

The Securities and Exchange Commission has further amended its net worth standard for accredited investors. This definition is an integral part of the rules that permit certain private and limited offerings to be made without registration—and without requiring specified disclosures—when sales are made only to accredited investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandated that the definition of accredited investor in rules issued under the Securities Act of 1933, as amended (Securities Act) be revised to exclude the value of a primary residence for purposes of determining whether a natural person, either individually or jointly with their spouse, has a net worth in excess of $1 million. While the change to this net worth standard became effective upon the enactment of the Dodd-Frank Act on July 21, 2010, the statute required the SEC to amend the Securities Act rules to conform to the new standard. Accordingly, on December 21, 2011, the SEC amended its rules to implement this Dodd-Frank Act provision. The amended net worth standard becomes effective on February 27, 2012.

The SEC amended the portion of the accredited investor definition that qualifies a natural person investor as accredited based on net worth under both Rule 501 of Regulation D and Rule 215 of the Securities Act. The SEC also adopted technical amendments to Form D and a number of other rules to conform them to the corresponding Dodd-Frank Act requirements.

The amendments reiterate that for the purpose of calculating net worth, a person's primary residence[1] shall not be included as an asset. Accordingly, under the amended rules, net worth is calculated excluding any positive equity that an individual may have in his or her primary residence. In making this calculation, indebtedness secured by the person's primary residence is generally offset against the estimated fair market value of the primary residence. Such debt generally is not included as a liability in calculating net worth, except to the extent it exceeds the estimated fair market value of the residence (i.e., an underwater mortgage).

The 60-Day Look-Back Period

Importantly, the amendments add a 60-day look-back provision requiring that any indebtedness that is secured by the primary residence (e.g., a home equity loan), and that was added within 60 days prior to a sale of securities, be included as a liability in calculating net worth (unless added as a result of the acquisition of the primary residence). In other words, such recently acquired debt must be stripped out in calculating net equity in a primary residence.

The look-back provision is intended to thwart efforts to manipulate the net worth standard by borrowing against the primary residence for the purpose of artificially inflating net worth to qualify as an accredited investor. Absent such provision, an investor could effectively convert home equity—which must be excluded from net worth—into cash or other assets permitted to be included in net worth.

Broker-dealers and issuers should ensure that their salespeople do not encourage prospective investors to borrow against their homes for the purposes of investing in unregistered offerings. The SEC considered a tracing provision that would require any debt secured by the primary residence to be included as a liability if the proceeds of such debt were used to invest in securities, but believed the 60-day look-back period to be simpler, more certain and a substantial disincentive to inappropriate sales practices. The SEC also noted that unscrupulous sales practices could be addressed through enforcement of existing Securities Act and broker-dealer rules, including NASD Rule 2310[2] requiring registered representatives of broker-dealers to make only suitable recommendations and certain anti-fraud rules under Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934, as amended.

Limited Grandfathering Provisions

The amendments provide a limited grandfathering provision in connection with an investor's exercise of certain preexisting rights to acquire securities so long as (i) the right was held by the investor on July 20, 2010, (ii) the investor qualified as an accredited investor on the basis of net worth at the time the right was acquired and (iii) the investor held securities of the same issuer, other than such right to acquire securities, on July 20, 2010. These preexisting contractual rights may include rights of first offer or first refusal, contractual preemptive rights, and rights arising under state law or under the constituent documents of an entity.

A capital call regarding a commitment that was made prior to enactment of the Dodd-Frank Act generally is *not* subject to using the amended definition (e.g., for a private equity fund or a closed-end real estate fund). However, new purchases in other private funds (e.g., hedge funds) will be subject to the amended definition unless the limited grandfathering provision applies. Funds that make use of a dividend or distribution reinvestment plan should also consider whether the use of such a plan results in the issuance of a new security under relevant SEC guidance.

Under the Dodd-Frank Act, the SEC is required to review the "accredited investor" definition in its entirety every four years after enactment of the Dodd-Frank Act, and to engage in further rulemaking to the extent it deems appropriate. On this timetable, the first SEC review will begin after July 21, 2014.

Private funds and other issuers should revise their subscription documents and investor questionnaires to clarify for investors the way in which home indebtedness should be treated.

Endnotes

[1] The amended rules do not define the term "primary residence." The adopting release references the commonly understood meaning of a home where a person lives most of the time.

[2] NASD Rule 2310 will be redesignated as FINRA Rule 2111 on July 9, 2012.

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