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## Legal Developments in Securities Law

### **Dodd-Frank Update: Final Rule on Accredited Investor Standard**

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This week, the SEC released a final rule on the net worth standard for accredited investors. The accredited investor standards, in Rules 215 and 501 under the Securities Act of 1933, are important to determine whether certain exemptions from registration apply under the securities laws. This is important with the following provisions:

- *Sec. 4(5) of the Securities Act:* Transactions involving offers or sales solely to one or more investors are exempt from registration if the aggregate offering price does not exceed \$5 million, there is no advertising or public solicitation and the issuer files notice with the SEC;
- *Reg D of the Securities Act:* Under the safe harbor provisions of Rule 505 or 506, the issuer is exempt from certain information requirements if sales are made only to accredited investors, and sales to such investors do not count

toward the 35 purchaser limit under these safe harbor provisions. Also, there is no sophistication requirement under Rule 506 for accredited investors.

Under Section 413(a) of Dodd-Frank, the SEC was required to make certain changes to the existing standard. Of greatest significance, the SEC has finalized the rule that now eliminates an individual's primary residence as an asset in the calculation of his net worth. Consistent with this approach, indebtedness secured by the person's primary residence is not counted as a liability, unless the indebtedness exceeds the net worth of the property, in which case the excess indebtedness is treated as a liability. Notably, the indebtedness secured by the primary residence contains a 60 day period, where any incremental increase in the amount of debt secured by a primary residence in the 60 days before the time of the net worth calculation of an individual generally will be included as a liability. This provision was included to prevent people from manipulating the rules by taking advantage of positive equity in their primary residence for the purposes of the net worth calculation.

If individuals previously qualified as an accredited investor, the new calculation of net worth will not apply to the purchase of securities in connection with a right to purchase such securities if:

- The individual had the right to purchase the securities at issue on July 20, 2010;
- The individual qualified as an accredited investor at the time the individual acquired the right to purchase the securities; and
- The individual held securities of the same issuer, other than the right to purchase securities of the issuer, on July 20, 2010.

The SEC defined the types of rights to purchase securities it envisioned as “[T]he exercise of statutory rights, such as pre-emptive 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 pre-emptive rights.”

The SEC noted that some of the costs involved will include potentially estimating a fair market value of the individual’s primary residence for purposes of calculating whether indebtedness exceeds the value of the home and making additional calculations if the individual increases indebtedness that is secured by the primary residence in the 60 days prior to the net worth calculation.

Further rulemaking on this issue is expected – Section 415 of the Dodd-Frank Act requires the Comptroller General of the United States to conduct a “Study and Report 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 SEC will use this information in future rulemaking on this issue. It is important for individuals who hope the take advantage of the exemptions related to the accredited investor standard to retain counsel with experience in this field and who will be able to offer advice on any future changes in these provisions.