



SEC Proposes Amendments to Its Net Worth Standard for Accredited Investors

As anticipated, on January 25, 2011, the Securities and Exchange Commission (the “SEC”) proposed amendments to the accredited investor standards in its rules under the Securities Act of 1933, as amended (the “Securities Act”), to reflect the requirements of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).¹ The SEC also proposed technical amendments to Form D and a number of rules to conform the language in the rules to the language of Section 413(a) and to correct cross-references to former Section 4(6) of the Securities Act, which was renumbered Section 4(5) by Section 944 of the Dodd-Frank Act.

We discuss the background, the proposed amendments to the accredited investor standards, and possible future SEC rulemaking below.

Background

The Dodd-Frank Act became law on July 21, 2010.² Among other things, the Dodd-Frank Act changed certain legal requirements governing private and other limited offers and sales of securities exempt from registration under the Securities Act. The Dodd-Frank Act provided that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be \$1 million, excluding the equity value (if any) of the investor’s primary residence. One year after enactment, the SEC is authorized to review the definition of the term “accredited investor” (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold. Four years after enactment, and every four years thereafter, the SEC must review the “accredited investor” definition as applied to natural persons, including adjusting the threshold, although it may not be lowered below \$1 million.

The SEC provided additional guidance regarding the net worth standard in a Compliance and Disclosure Interpretation (the “C&DI”). The C&DI notes that:

“Section 413(a) of the Dodd-Frank Act does not define the term “value,” nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person’s primary residence must be excluded. Pending implementation of the changes to the Commission’s rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair

¹ The Proposing Release is available at <http://www.sec.gov/rules/proposed/2011/33-9177.pdf>.

² Pub. L. No. 111-203, 124 Stat. 1376.

market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth."³

The Dodd-Frank Act requires the SEC to promulgate rules, within one year of enactment, disqualifying persons determined to be "bad actors" from eligibility to use Rule 506 under Regulation D. A "bad actor" includes any person who is subject to a final order by a state securities, banking or insurance authority, a federal banking regulator, or the NCUA that: bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance, or banking, (3) engaging in savings association or credit union activities; or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of filing of the Form D relating to the offer or sale; or who has been convicted of any felony or misdemeanor in connection with the purchase or sale of a security or involving the making of any false filing with the SEC.

Discussion of the Proposed Amendments to Net Worth

As amended, Rules 215(e) and 501(a)(5) would define as an accredited investor:

"Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of purchase, exceeds \$1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property."

The proposed amendments would set the same standard under both Rule 501 and Rule 215 for individuals to qualify as accredited investors on the basis of net worth, either individually or with their spouses.

The amendments (as proposed) implement Section 413(a) by adding the statutory language⁴ to the relevant SEC rules. In addition, the proposed amendments add the phrase "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property." The SEC states that the purpose of adding this phrase is to clarify that net worth is calculated by excluding only the investor's net equity in the primary residence.

The SEC notes that it believes this approach is appropriate because it is consistent with, and advances the regulatory purposes of, Section 413(a). It reduces the net worth measure by the amount or "value" that the primary residence contributed to the investor's net worth before enactment of Section 413(a). The SEC also notes that some existing rules, for example Rule 701 under Regulation R, follow an approach similar to this proposal in calculating net worth.⁵

Section 413(a), the change that removed the value of the primary residence from the net worth calculation, became effective upon enactment of the Dodd-Frank Act. Thus, we expect that most issuers and agents have already made the appropriate adjustments to their subscription documents and investor questionnaires.

Requests for Comments and Future Rulemaking

The SEC is soliciting comments on its proposal and a number of questions that it raises in the proposal. Comments are due on March 11, 2011.

³ C&DI July 23, 2010, Question 179.01.

⁴ Section 413(a) provides the phrase "excluding the value of the primary residence of such natural person."

⁵ Rule 701, which provides for the exclusion of the value of a person's primary residence in applying a net worth standard, provides for the exclusion of "associated liabilities," such as mortgages on the property.

In addition, as noted above, Section 413(b) specifically authorizes the SEC to undertake a review of the definition of “accredited investor” as it applies to natural persons, and requires the SEC to undertake a review of the definition “in its entirety” every four years, beginning four years after enactment of the Dodd-Frank Act. Moreover, the SEC is authorized to engage in rulemaking to make adjustments to the definition after each such review. While the SEC states that it may consider future rulemaking, at this point in time, the SEC is not proposing to make revisions to the definitions of “accredited investor” that are not required by the Dodd-Frank Act.

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Contact a member of MoFo’s Private Equity Fund Group with any additional questions.

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