

LEGAL UPDATE

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DODD-FRANK REDUX: SEC SEEKS TO CLARIFY “ACCREDITED INVESTOR” NET WORTH CALCULATION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Among other things, the new law revised the “net worth” prong of the “accredited investor” standard used in connection with certain securities offerings which are exempt from registration under the Securities Act of 1933, as amended (the “Securities Act”). The Dodd-Frank Act provided that, effective immediately, the value of an individual investor’s primary residence must be excluded in determining whether an investor meets the \$1 million threshold net worth necessary to qualify as “accredited.”

Section 413(a) of the Dodd-Frank Act also requires that the SEC amend its rules under the Securities Act to reflect this revised net worth standard. On January 25, 2011, the Securities and Exchange Commission (the “SEC”) issued its release (the “Release”)¹ proposing such rule amendments and adding additional language to the standard to clarify how to calculate the amount of the “value” of the primary residence which must be excluded. In addition to requesting comment on the rule changes, the Release also seeks feedback on whether there is a need to address certain transitional issues, such as follow-on investments by investors who have previously invested with an issuer as accredited investors but who would cease to qualify as a result of the change in the accredited investor test.

¹ See the proposed rules at SEC Release No. 33-9177 (January 25, 2011). Available online at: <http://www.sec.gov/rules/proposed/2011/33-9177.pdf>.

BACKGROUND

An issuer can offer securities without registration under the Securities Act pursuant to exemptions articulated by the Securities Act and SEC rules (such as Section 4(5)² and Rule 506³). An issuer may provide less comprehensive disclosure and allow potentially more investors under these exemptions if the offerings are made only to persons who qualify as “accredited investors.” Historically, individuals who were not executive officers of the issuer could qualify as accredited either by meeting an income test⁴ or by having a “net worth” of at least \$1 million, either alone or together with such individual’s spouse. However, neither the Securities Act nor the SEC’s rules have previously indicated how to calculate “net worth.” As a result, net worth was generally calculated in the traditional manner – the amount by which all of the individual’s assets, including his or her “principal residence” exceeded his or her total liabilities.

Although the Dodd-Frank Act left the income test unchanged, Section 413(a) of the statute⁵ mandated

² Formerly Section 4(6), 15 USC 77d(6). The Dodd-Frank Act deleted former Section 4(5) and renumbered former Section 4(6) as Section 4(5).

³ 17 CFR 230.506.

⁴ The income test requires “an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and . . . a reasonable expectation of reaching the same income level in the current year.” Rule 501(a)(6), 17 CFR 230.501(a)(6).

⁵ To be codified at 15 USC 77b.

that during the 4-year period beginning on the date of enactment, “any net worth standard [for accredited investors] shall be \$1,000,000, excluding the value of the primary residence” of the individual.⁶ The section also mandated that the SEC amend its rules to reflect that “the value of the primary residence of such natural person” was to be excluded in the calculation of a potential investor’s net worth.

PROPOSED RULE CHANGE

As a result of the requirements of the Dodd-Frank Act, the SEC has proposed to amend the “net worth” standard for accredited investors as follows:

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.⁷

The Release points out that the purpose of adding the phrase introduced by the words “calculated by”

⁶ (Emphasis added.) Once the specified four-year period has expired, and no less frequently than once every four years thereafter, the SEC is tasked with reviewing the “accredited investor” standard as it applies to individuals, including both the net worth and income tests, and making such adjustments to the definition as it deems appropriate. Section 415 of the Dodd-Frank Act requires the Comptroller General of the United States to conduct a study (due three years after enactment) examining “the appropriate criteria for determining the financial thresholds . . . needed to qualify for accredited investor status. . . .” Future rulemaking likely will reflect recommendations proposed by the Comptroller General.

⁷ Shortly after enactment of the Dodd Frank-Act, the staff issued a Compliance and Disclosure Interpretation providing guidance on how to determine the “value of the primary residence” for purposes of calculating an investor’s net worth. Compliance and Disclosure Interpretations, Securities Act Rules, Question 179.01 [July 23, 2010]. The proposed rule revision tracks this interpretation.

is to clarify that net worth is calculated by excluding only the investor’s net equity in the primary residence⁸ – effectively the “value” that the primary residence contributed to the investor’s net worth before enactment of Section 413(a). It expresses the SEC’s belief that this approach is more consistent with the intent of the statute (as well as more consistent with certain of its other rules) than either excluding the fair market value of the residence without netting out the secured indebtedness or excluding both the fair market value of the residence and all indebtedness secured by it.

Under the proposed definition, net worth would initially be calculated “in the conventional manner” by subtracting from an investor’s total assets (including the value of the primary residence) the investor’s total liabilities (including indebtedness secured by the primary residence). There would then be deducted from the result the “value” of the primary residence as described above – its fair market value less the indebtedness secured by it. As an example, if the investor has a net worth of \$2,000,000, but that calculation includes a house worth \$1.2 million securing a mortgage of \$800,000, the investor’s net worth would be reduced by \$400,000 (the amount by which the value of the house exceeds the secured debt). Thus, the investor’s net worth would be considered to be \$1.6 million.

The Release requests comments by March 11, 2011 on the proposed changes. Comments are also requested regarding a number of other issues, such as whether to define the term “primary residence” and whether to anticipate certain potential methods for evading the test. In addition, the SEC is seeking comments to address issues which may arise with regard to subsequent investments by investors who previously qualified as accredited but have become disqualified by the change effected by the Dodd-Frank Act. Examples of these types of issues include how to treat rights of investors who are no longer accredited either to make follow-on investments in order to maintain their proportionate interests in the issuer or to exercise other rights to

⁸ The proposed amendments change the current terminology of “principal residence” to “primary residence” to conform to the language of the Dodd-Frank Act.

acquire securities which have arisen as a result of the original investment (such as pre-emptive rights or rights of first refusal) and whether an issuer that wishes to make a rights offering should be subject to the additional information requirements it would incur under Regulation D if it offers and sells securities to existing investors who have become non-accredited investors.

RECOMMENDATIONS

Since the change in the net worth standard under the Dodd-Frank Act is already effective, issuers should have previously revised their investor questionnaires and subscription agreements to reflect the exclusion of the value of an investor's primary residence from the net worth calculation. Pending release of the final rules, it is probably advisable to revisit earlier revisions of these documents to ensure that investors' previous calculations of their own net worth satisfy the definition contained in the Release. Issuers that have completed or are currently conducting private offerings may also wish to determine whether

investors admitted on the basis of their net worth continue to qualify as accredited under the proposed test.

The foregoing is intended to summarize the SEC's proposed rules for determining "net worth" of accredited investors, and does not constitute legal advice. Please contact the Pryor Cashman attorney with whom you work with any questions you may have. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at (212) 326-0146.

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Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and other technology.

Mr. Goodman has also written on topics ranging from issues confronting unregistered finders to raising seed capital for entrepreneurial companies and has lectured on various aspects of pharmaceutical/biotech collaboration agreements.

Mr. Goodman has been responsible for negotiating and documenting the following representative transactions:

- On behalf of the placement agent, a PIPE transaction for a publicly-traded Chinese company in the catering and restaurant sales businesses primarily in the People's Republic of China
- On behalf of a multi-national professional publishing company, acquisitions of the stock or assets of more than thirty targets, in transactions ranging in value up to \$1 billion, including acquisitions involving counsel in multiple jurisdictions, auction transactions and several involving friendly tender offers for the stock of publicly-traded companies
- On behalf of a development stage biotechnology company, a private financing of \$8.4 million to advance a client's two lead drug programs and a "double-dummy" reverse merger with a second biotechnology company, creating a single company with multiple drug programs which was purchased by a public pharmaceutical company for more than \$100 million
- On behalf of an early pioneer in internet music delivery, two private preferred equity financings, the second led by a major hedge fund
- On behalf of a public company in the field of monoclonal antibody research, an initial and a secondary public offering

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.