Important Modifications to Accredited Investor Definition — Effective Late February 2012

On December 21, 2011, the Securities and Exchange Commission adopted amendments[1] to the definition of an "accredited investor" under Regulation D, promulgated under the Securities Act of 1933. One of the standards for an accredited investor requires individuals to have at least $1 million in net worth, excluding the value of his or her primary residence, and that debt secured by the primary residence not be included as a liability (with exceptions). This amendment implements the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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By operation of law, upon enactment of the Dodd-Frank Act on July 21, 2010, the definition of "accredited investor" in Rule 501(a)(5) of the Securities Act was modified to provide that to qualify as an accredited investor based solely on net worth, an individual must have (alone or together with his or her spouse) a net worth in excess of $1 million, *excluding the value of his or her primary residence*. Dodd-Frank required the SEC to adjust the accredited investor net worth standard in Securities Act Rules 501 and 215[2] to conform these rules to the modified standard.

As amended, the individual net worth standard requires that, in calculating net worth:

- the primary residence not be included as an asset; and
- debt secured by the primary residence not be included as a liability, *except that*
  - if the amount of debt secured by the primary residence has increased in the 60 days preceding the accredited investor determination, other than in connection with the acquisition of the residence, the amount of such increase must be included as a liability; and
  - if the amount of debt secured by the primary residence exceeds the estimated fair market value of the primary residence, the amount of such excess must be included as a liability.

The amended rule provides that "incremental debt" secured by an investor's primary residence that is incurred in the 60-day period before the purchase of securities will be included as a liability.[3] The Release specifically states that when performing the net worth calculation, an investor who has re-financed his or her primary residence within the 60-day look-back period must treat the incremental debt as a liability *even if the value of the primary residence exceeds the amount of the debt* secured by the residence.

As noted, the value of the primary residence is not included in calculating an investor's net worth. If debt is incurred by the investor in connection with the acquisition of the primary residence, the debt is also excluded from the calculation. However, if the mortgage is underwater, the excess of the mortgage over the fair market value of the primary residence will be included as a liability in the net worth calculation.

As under the prior rule, net worth is calculated at the time of the purchase of securities. The rule requires only an estimated fair market value and no third party valuation or appraisal is required.[4]

The amendment also includes a transitional provision — the former accredited investor net worth test[5] will apply to acquisitions of securities pursuant to rights to acquire securities if:

- the rights were held on July 20, 2010;
- the person qualified as an accredited investor on the basis of the net worth definition at the time the rights were acquired; and
- the person held securities of the issuer, excluding these rights, on July 20, 2010.

These grandfathering provisions apply to the exercise of statutory rights which may include pre-emptive rights arising under state law; rights arising under an entity's constituent documents; rights of first refusal; and contractual rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible security.

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1 See Sec. Act Release No. 33-9287 (Dec. 21, 2011) (the "Release").

2 17 CFR 230.501(a)(5) and 230.215(e).

3 See amended rule at § 230.501(a)(5)(i)(B).

4 The Release, at page 34.

5 Under the former standard, the value of a primary residence could be included in a calculation of net worth in determining whether an individual was an accredited investor.