

SEC Proposes Amendment to “Accredited Investor” Net Worth Test to Exclude Primary Residence per Dodd-Frank Act Requirement

On January 25, 2011, the Securities and Exchange Commission (“SEC”) issued proposed rules that would change the definition of “accredited investor” in its rules under the Securities Act of 1933, as amended (the “Securities Act”), in accordance with the requirements of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).¹ As required by Section 413(a) of the Dodd-Frank Act, the SEC is proposing to exclude the value of a person’s primary residence from the person’s net worth for purposes of determining who qualifies as an “accredited investor.”

The SEC is seeking comment on its proposed rules by March 11, 2011.

I. Proposed Amendments to Net Worth Standards for Accredited Investors

The net worth standards for accredited investors, found in the SEC’s rules under the Securities Act, “delineate investors to whom issuers may sell securities in specified private and other limited offerings without registration of the offering under the Securities Act.”² These standards apply to a natural person individually, or jointly with a spouse, and require a minimum net worth of more than \$1,000,000. Section 413(a) of the Dodd-Frank Act requires the SEC to adjust the net worth standards for accredited investors to exclude “the value of the primary residence of such natural person.”³

The SEC is proposing amendments to Securities Act Rules 501 and 215 to reflect the exclusion required by Section 413(a) of the Dodd-Frank Act. In addition to adding the phrase “excluding the value of the primary residence of such natural person” after the requirement that the investor’s net worth “exceed[] \$1,000,000,” the SEC’s proposed rules would clarify that the value of the primary residence would be “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.”⁴ This latter phrase elucidates that in calculating net worth, only the investor’s net equity in the primary residence is excluded; in other words, only the value that the primary residence contributed to the investor’s net worth prior to the enactment of Section 413(a) would be excluded in calculating the investor’s net worth. Moreover, with the addition of this phrase the SEC is proposing that “indebtedness secured by the primary residence would be netted against the value of the primary residence only up to the fair market value of the property.”⁵ The SEC’s rationale is that a rule permitting a deduction from the property’s market value in the full amount of the secured indebtedness when such indebtedness exceeds the value of the property would result in increased net worth as compared to a conventional net worth calculation.

Because Section 413(a) of the Dodd-Frank Act became effective upon the Dodd-Frank Act’s enactment, the SEC is not proposing rules to facilitate transition to the new accredited investor net worth standards.⁶

¹ See *Net Worth Standard for Accredited Investors*, Release No. 33-9177; IA-3144; IC-29572; File No. S7-04-11 (January 25, 2011), available at <http://www.sec.gov/rules/proposed/2011/33-9177.pdf>.

² *Id.* at 4.

³ *Id.* (quoting Dodd-Frank Act § 413(a)).

⁴ *Id.* at 7.

⁵ *Id.* at 10.

⁶ In addition to the proposed amendments to the accredited investor net worth standards, the SEC proposes technical

II. Other Issues Considered by the SEC

The SEC considered, but ultimately declined to adopt (at least as of now), additional amendments to the net worth standards for accredited investors:

1. The SEC considered defining the term “primary residence,” but determined that such definition would introduce “unnecessary complexity” and that issuers and investors could rely upon the commonly understood meaning of the term and obtain guidance, when necessary, from rules that apply in other contexts.⁷
2. The SEC considered a proposal from the North American Securities Administrators Association (“NASAA”) that debt secured by a primary residence not be excluded from the calculation of net worth if the proceeds of the debt are used to invest in securities. The NASAA’s concern is that investors may take out a mortgage “in order to manipulate their status under the accredited investor test and to use the proceeds to invest in what would otherwise be unsuitable private placement securities.”⁸ In the SEC’s opinion, however, “a rule that attempts to trace the use of mortgage or home equity loan proceeds and to distinguish between permissible and impermissible uses of proceeds would introduce undue complexity into Regulation D.”⁹
3. As noted above, the SEC is not currently proposing any special rules for transition to the new accredited investor net worth standards. As of now, “[i]nvestors must satisfy the applicable accredited investor income or net worth standard in effect at the time of every exempt sale of securities to the investor that is made in reliance upon the investor’s status as such.”¹⁰ Nonetheless, the SEC is seeking comment on whether transition rules “might be appropriate to facilitate subsequent investments by an investor who previously qualified as accredited but was disqualified by the change effected by the Dodd-Frank Act.”¹¹

III. Conclusion

The SEC’s current proposed amendments to the net worth standards for accredited investors implement the requirements of Section 413(a) of the Dodd-Frank Act. In the course of the SEC’s future statutorily-mandated

amendments, such as changing a reference in Rule 501 from “principal residence” to “primary residence” for the sake of conformity.

⁷ *Id.* at 12.

⁸ *Id.* at 13 (quoting Advance Comment Letter from NASAA (Nov. 4, 2010), at 2).

⁹ *Id.*

¹⁰ *Id.* at 14.

¹¹ *Id.* On the issue of potential transition rules, Commissioner Troy A. Paredes has expressed reservations regarding the fact that as a result of the proposed rules an investor who loses his or her “accredited” status “may not be allowed to make a subsequent investment in a company or a fund the investor had earlier invested in through a prior Regulation D offering.” In Commissioner Paredes’ opinion, this could disadvantage both the investor and the issuers. Commissioner Paredes has therefore requested that commenters address whether the SEC should allow “grandfathering” of an investor’s “accredited” status for the purpose of allowing such investors to make follow-on investments in companies or funds in which they have already invested. *See* Speech by SEC Commissioner: Statement at Open Meeting to Propose Rules Regarding Net Worth Standard for Accredited Investors (January 25, 2011), available at <http://www.sec.gov/news/speech/2011/spch012511tap-2.htm>.

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reviews of the definition of the term “accredited investor,” and following the anticipated study of the Comptroller General of the United States with regard to accredited investors, the SEC may propose further rules on the subject.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Yafit Cohn at 212.701.3089 or ycohn@cahill.com.