

## SEC Adopts Amendments to “Accredited Investor” Net Worth Test to Exclude Primary Residence

On December 21, 2011, the Securities and Exchange Commission (“SEC”) adopted amendments that change the definition of “accredited investor” in its rules under the Securities Act of 1933, as amended (“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”).<sup>1</sup> As required by Section 413(a) of the Dodd-Frank Act, which became effective upon the Dodd-Frank Act’s enactment, the SEC’s new rules exclude the value of a person’s primary residence for the purposes of determining whether that person is an “accredited investor” on the basis of having a net worth in excess of \$1,000,000.<sup>2</sup> The SEC’s revised definition of “accredited investor” is largely consistent with the approach taken in the SEC’s proposing release of January 25, 2011<sup>3</sup> and with the SEC staff’s initial analysis of Section 413(a).<sup>4</sup> The SEC also adopted technical amendments to Form D and to some of its other rules to conform them to the requirements of Section 413(a).

### **I. Amendments to Net Worth Standards for Accredited Investors**

The net worth standards for accredited investors, set forth in Rules 215 and 501 under the Securities Act, “are used in determining the availability of certain exemptions from Securities Act registration for private and other limited offerings.”<sup>5</sup> These standards apply to natural persons individually, or jointly with their spouse, and require a minimum net worth of more than \$1,000,000. “One purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore less liquid) securities for an indefinite period and, if necessary, to afford a complete loss of such investment.”<sup>6</sup>

Section 413(a) of the Dodd-Frank Act removed the value of a person’s primary residence from the net worth calculation and required the SEC to amend the accredited investor net worth standard in its rules accordingly. After reviewing comments received in response to its proposing release, the SEC adopted identical

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<sup>1</sup> See *Net Worth Standard for Accredited Investors*, Release No. 33-9287; IS-3341; IC-29891; File No. S7-04-11 (December 21, 2011), available at <http://www.sec.gov/rules/final/2011/33-9287.pdf>.

<sup>2</sup> Notably, the SEC has declined to define the term “primary residence” in order “to avoid unnecessary complexity in a rule that is intended to be straightforward in application.” *Id.* at 21. The SEC believes that “‘primary residence’ has a commonly understood meaning as the home where a person lives most of the time.” *Id.*

<sup>3</sup> 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>. See also Memorandum of Cahill Gordon & Reindel LLP, *SEC Proposes Amendment to “Accredited Investor” Net Worth Test to Exclude Primary Residence per Dodd-Frank Act Requirement* (January 28, 2011), available at [http://www.cahill.com/news/memoranda/100263/res/id=sa\\_File1/CGR%20Memo%20-%20New%20Worth%20Standards%20for%20Accredited%20Investors.pdf](http://www.cahill.com/news/memoranda/100263/res/id=sa_File1/CGR%20Memo%20-%20New%20Worth%20Standards%20for%20Accredited%20Investors.pdf).

<sup>4</sup> *Net Worth Standard for Accredited Investors*, Release No. 33-9287, *supra* note 1, at 9 n.33 (citing Securities Act Rules Compliance & Disclosure Interpretation, Question No. 255.47 (July 23, 2010)).

<sup>5</sup> *Id.* at 3.

<sup>6</sup> *Id.* at 4.

amendments to Rules 215 and 501 to include the new standard for individual net worth in the “accredited investor” definition. The revised standard states that for purposes of calculating net worth, “[t]he person’s primary residence shall not be included as an asset.”<sup>7</sup>

The revised standard also discusses the treatment of mortgage debt in calculating net worth. It provides that “[i]ndebtedness that is secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability. . . .”<sup>8</sup> Thus, in the calculation of net worth, only positive equity in a person’s primary residence is excluded. The SEC explained that it believed this approach to be the “most appropriate way” to conform its rules to Section 413(a), since “the value of a person’s primary residence” is commonly understood to be “the net amount that the primary residence contributed to net worth before enactment of Section 413(a).”<sup>9</sup> An exclusion of the residence as a whole, according to the SEC, “would reduce net worth by more than the amount the residence contributes.”<sup>10</sup> The SEC’s final rules also “specify that debt secured against the primary residence in excess of the estimated fair market value of the primary residence must be treated as a liability in the net worth calculation.”<sup>11</sup> The SEC reasoned that “if the amount of mortgage debt exceeds the value of the primary residence (*i.e.*, an underwater mortgage), excluding the entire debt from net worth for purposes of the accredited investor definition would result in a higher net worth than under a basic net worth calculation that takes into account all assets and all liabilities.”<sup>12</sup>

In order to address concerns that investors might artificially inflate their net worth “by incurring incremental indebtedness secured by their primary residence, thereby effectively converting their home equity – which is excluded from the net worth calculation under the [new] rules . . . – into cash or other assets that would be included in the net worth calculation,” the SEC included in its final rules a provision specifically pertaining to “incremental debt secured by the primary residence that is incurred in the 60 days before the sale of securities.”<sup>13</sup> Unlike mortgage debt generally, an increase in the amount of debt secured by one’s primary residence that occurs in the 60 days before the sale of securities is treated as a liability; in other words, the person’s net worth will be reduced by the amount of that incremental debt. According to the SEC, this provision, which will make it more difficult for individuals to manipulate their net worth, should “significantly reduce the incentive for individuals to try to ‘game’ the accredited investor net worth standard or for salespeople to attempt to induce individuals to take on incremental debt secured against their homes to facilitate a near-term investment in an offering.”<sup>14</sup>

The SEC’s final rules also contain a limited grandfathering provision “under which the former accredited investor net worth test will apply to purchases of securities in accordance with a right to purchase such securities, so long as (i) the right was held by a person on July 20, 2010, the day before the enactment of the Dodd-Frank Act; (ii) the person qualified as an accredited investor on the basis of net worth at the time the right was acquired;

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<sup>7</sup> *Id.* at 8 (quoting new individual net worth standard in the “accredited investor” definition).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 9-10.

<sup>10</sup> *Id.* at 10.

<sup>11</sup> *Id.* at 13.

<sup>12</sup> *Id.* at 11.

<sup>13</sup> *Id.* at 14-15.

<sup>14</sup> *Id.* at 16.

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and (iii) the person held securities of the same issuer, other than the right, on July 20, 2010.”<sup>15</sup> In the SEC’s opinion, this provision “strikes an appropriate balance between preserving investors’ ability to exercise previously bargained-for rights, which otherwise may have been impaired by the change in accredited investor definition, and maintaining the investor protection benefits that Section 413(a) seeks to achieve.”<sup>16</sup>

## II. Technical and Conforming Amendments

The SEC adopted several technical amendments in order to conform its rules to the requirements of Section 413(a).

- In Rule 501(e)(1)(i) of Regulation D, the SEC changed “principal residence” to “primary residence” in order to mirror the new language in Rule 501.
- Because former Section 4(6) of the Securities Act was renumbered by the Dodd-Frank Act, the SEC changed references to Section 4(6) to Section 4(5) in Form D under the Securities Act and in various other rules under the Securities Act, the Investment Company Act, and the Investment Advisers Act.

## III. Conclusion

The SEC’s recent 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 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 adopt 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](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); or Yafit Cohn at 212.701.3089 or [ycohn@cahill.com](mailto:ycohn@cahill.com).

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<sup>15</sup> *Id.* at 19-20.

<sup>16</sup> *Id.* at 20. Along with the 60-day look-back provision described above, this grandfathering provision is one of the “most significant revisions” from the SEC’s proposal of January 25, 2011. *Id.* at 5.