December 23, 2011

SEC Adopts Final Dodd-Frank Definition of Accredited Investor

On December 21, 2011, the Securities and Exchange commission ("SEC") adopted amendments to its rules in order to conform its definition of an "accredited investor" to the requirements of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Release No. 33-9287, December 21, 2011, available at http://www.sec.gov/rules/final/2011/33-9287.pdf. The Dodd-Frank Act requires that the value of a person's primary residence be excluded from the net worth calculation used to determine the person's "accredited investor" status for purposes of determining eligibility for investing in certain securities offerings that are exempt from registration. The prior rule defined "accredited investor" to include a person with a net worth of $1 million, including the value of the person's primary residence.

Under the amended rule, the value of an individual's primary residence will not count as an asset when calculating net worth to determine "accredited investor" status. The amendments also clarify the treatment of borrowing secured by a primary residence for purposes of the net worth calculation. Under certain circumstances, they also permit individuals who qualified as accredited investors under the pre-Dodd-Frank Act definition of net worth to use that prior net worth standard for certain follow-on investments.

Under the amended net worth calculation, indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence, is not treated as a liability, unless the borrowing occurs in the 60 days preceding the purchase of securities in the exempt offering and is not in connection with the acquisition of the primary residence. In such cases, the debt secured by the primary residence must be treated as a liability in the net worth calculation. The SEC stated that this is intended to prevent manipulation of the net worth standard, by eliminating the ability of individuals to artificially inflate net worth under the new definition by borrowing against home equity shortly before participating in an exempt securities offering. In addition, any indebtedness secured by a person's primary residence in excess of the property's estimated fair market value is treated as a liability under the new definition.

As an example under the new definition, if an investor has a net worth of $1.5 million including a primary residence with a value of $1 million, other net assets worth $1 million and a mortgage of $500,000, the value of the primary residence will be excluded as an asset and the mortgage amount will be excluded as a liability (unless the mortgage was incurred within the 60 days preceding the securities purchase and was not in connection with the acquisition of the residence); hence the investor's net worth under the rule will be $1 million. If the mortgage indebtedness was $1.2 million, the excess of the debt over the value of the residence, $200,000, would be included as a liability and the investor's net worth under the rule would be $800,000.

The new definition permits limited grandfathering in connection with an investor's exercise of certain pre-existing rights to acquire securities which include the exercise of statutory rights, such as pre-emptive rights arising under state law; rights arising under an entity's constituent documents; and contractual rights, such as rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible instrument, rights of first offer or first refusal and contractual pre-emptive rights, so long as:

- such right was held by the person on July 20, 2010;

- the person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and

- the person held securities of the same issuer, other than such right, on July 20, 2010.

The amended net worth standard will take effect 60 days after publication in the Federal Register. Beginning in 2014, and every four years thereafter, the Dodd-Frank Act requires the SEC to review the “accredited investor” definition in its entirety and to engage in further rulemaking to the extent it deems appropriate.

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