

# Client Alert

January 2012

## SEC Adopts Rules Relating to Net Worth Standard for Accredited Investors

### SEC Implementation of the Dodd-Frank Wall Street Reform Act

On December 21, 2011, the Securities and Exchange Commission (“SEC”) adopted new rules under the Securities Act of 1933, as amended (the “Securities Act”), as required by Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The rules exclude the value of a person’s primary residence for purposes of determining whether the person qualifies as an “accredited investor” on the basis of having a net worth in excess of \$1 million. A copy of the SEC’s release is available [here](#).

### Background

Section 413(a) of Dodd-Frank changed the net worth standard for accredited investors who are natural persons to exclude the value of the primary residence of such persons, effective upon enactment on July 21, 2010, but directed the SEC to revise the Securities Act rules to reflect the new standard. Before Dodd-Frank, the accredited investor rules permitted the primary residence to be included in calculating net worth. In late July 2010, following enactment of Dodd-Frank, the SEC issued a Compliance and Disclosure Interpretation relating to Section 413. On January 25, 2011, the SEC proposed rules as directed by Section 413. Please see our prior [memorandum](#) for additional information regarding the SEC’s rule proposal.

Section 413(b) of Dodd-Frank directs the SEC to review the definition of the term “accredited investor” as it applies to natural persons, and requires the SEC to review the definition in its entirety every four years. The SEC did not adopt additional changes to the “accredited investor” definition at this time, but may do so in the future.

### Net Worth Standard

The SEC amended the definition of “accredited investor” as it applies to natural persons in Rule 501 in connection with the exemptive provisions for private offerings under Regulation D. The SEC also amended Rule 215 relating to offerings exclusively under Section 4(5) of the Securities Act (formerly numbered as Section 4(6)).

The new accredited investor definition will include any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of purchase exceeds \$1 million. For purposes of calculating net worth:

- The person’s primary residence shall not be included as an asset;
- Indebtedness 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 (except that if the amount of such indebtedness outstanding at the time of the sale of securities exceeds the amount outstanding 60 days before such time,

- other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and
- Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability.

Consistent with the proposals and earlier SEC interpretive guidance, debt secured by the primary residence generally will not be included in the calculation except to the extent it exceeds the estimated value of the residence, such as when the mortgage is under water. In response to comments, the SEC also included in the final rule the requirement to include as a liability any incremental debt secured by the primary residence incurred within 60 days of the sale of securities. As a result, issuers may wish to revise their subscription documents for private placements to address this new 60-day look-back provision.

The SEC also solicited comment on whether it should define the term "primary residence" and whether the rule should address the proceeds of debt secured by the primary residence and used to invest in securities. However, the SEC declined to include these items in the final rules.

### **Effective Date and Grandfathering**

The new rules will be effective February 27, 2012. Because the new net worth standard was effective upon enactment of Dodd-Frank, the SEC included only a limited grandfathering provision and no transition period.

In response to comments, the SEC included in the new rules a provision under which the old accredited investor net worth test will apply to purchases of securities in accordance with a preexisting right to purchase such securities (such as statutory preemptive rights, rights granted under the issuer's constituent documents and contractual rights) only if:

- The right was held by a person on July 20, 2010, the day before the enactment of Dodd-Frank;
- The person qualified as an accredited investor on the basis of net worth at the time the right was acquired; and
- The person held securities of the same issuer, other than the right, on July 20, 2010.

### **Additional Information**

The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on [www.huntonfinancialindustryresourcecenter.com](http://www.huntonfinancialindustryresourcecenter.com). For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our [prior memoranda](#) available on our website at [www.hunton.com](http://www.hunton.com).

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