New Accredited Investor Net Worth Test to Impact Private Investment

By Alon Y. Kapen, Esq. of Farrell Fritz, P.C.

In the Dodd-Frank Act passed last year, Congress required that an individual's primary residence be excluded from the $1million net worth test for accredited investor status. On January 25, 2011, the SEC issued proposed rules to implement the exclusion. The new net worth test will undoubtedly reduce the pool of prospective accredited investors, have a negative impact on companies' prospects for raising capital and will require companies to review and make changes to their offering documents to conform to the new rules.

Background

Securities offered to accredited investors receive favored status under the Securities Act of 1933 (the "Securities Act") and rules promulgated thereunder. Section 4(5) of the Securities Act provides an exemption from registration and prospectus delivery requirements for a maximum of $5 million of securities offered or sold solely to accredited investors with no advertising or public solicitation. Under the safe harbor exemptions of Regulation D's Rules 505 and 506, securities may be sold to an unlimited number of accredited investors but not more than 35 non-accredited investors. In addition, the mandated specific disclosure requirements of Regulation D need not be satisfied if the securities are sold only to accredited investors, which explains why many private placements are offered only to accredited investors.

Under the Securities Act and Regulation D, an individual qualifies as an accredited investor if he or she earned $200,000 or more (or $300,000 jointly with the individual's spouse) in each of the last two years (with a reasonable expectation of exceeding the threshold in the current year) or if he or she had a net worth of $1 million (alone or jointly with his or her spouse). These amounts have not changed since they were adopted in 1982.

Until last year, the equity in an individual's primary residence was included in the calculation of net worth. Section 413 of Dodd-Frank, however, requires that the value of an individual's primary residence be excluded from the calculation, and called on the SEC to promulgate new rules on the primary residence exclusion and to revisit the entire accredited investor definition every four years.

The Proposed Rule

Dodd Frank's requirement that the value of a primary residence be excluded from the calculation of net worth left unclear the treatment of mortgage debt, particularly when that debt is underwater (i.e., where the debt amount exceeds the property's fair market value). The SEC is now proposing that the value of a person's primary residence be "*calculated by subtracting from the property's estimated fair market* *value the amount of debt secured by the property, up to the estimated fair market value*". [1] Effectively, under the proposed rule, net worth would mean the excess of total assets at fair market value (excluding the value of the primary residence) over total liabilities (excluding indebtedness secured by the primary residence), provided that if the primary residence is underwater, then the excess debt would be treated as a liability and deducted from net worth. The only guidance as to the meaning of primary residence in the SEC's release is that it should be understood to mean "the home where a person lives most of the time".

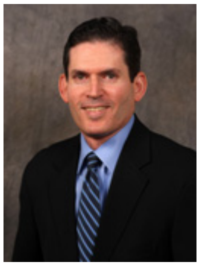
The exclusion of an individual's primary residence from the calculation of net worth will significantly reduce the pool of eligible accredited investors and have a negative impact on private equity markets in the United States. Using the latest data available from the 2007 Federal Reserve Board Survey of Consumer Finances, the SEC estimates that the number of households qualifying for accredited investor status will decline 28% as a result of the SEC's new rule, from 10.5 million to 7.6 million. The damage would be even greater, however, under an alternative interpretation (not adopted by the SEC) of Dodd Frank's primary residence exclusion (in which none of a primary residence's debt would be excluded from the net worth calculation), which would reduce the number of net worth eligible accredited investor households to 6.9 million, a 35% drop. [2]

The net worth test for individuals will likely get more stringent in the future, making it even more difficult for companies to raise capital from private investors. Section 413 requires the SEC at least once every four years to undertake a review of the entire definition of the term "accredited investor" to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest and in light of the economy. While Congress stopped short of dictating standards (except for the primary residence exclusion), the mere fact that the SEC is required to review the accredited investor definition on a periodic basis is likely to result in higher net worth and income tests over time.

In its proposed rule release, the SEC solicited comments on its proposal generally and also on a number of specific questions posed in the release. The deadline for submission of comments was March 11, 2011. Comment letters received by the SEC are available at **http://www.sec.gov/comments/s7-04-11/s70411.shtml**. The SEC is scheduled to issue final rules between May and July of this year.

Because the primary residence exclusion became effective July 21, 2010, companies and private funds raising capital should review their offering documents, including investor suitability questionnaires, purchase agreements and private placement memoranda, to ensure conformity with the new net worth component of the accredited investor suitability standards.

Alon Y. Kapen, Esq., Partner, akapen@farrellfritz.com



Alon Y. Kapen is a partner in the corporate department, concentrating in corporate securities transactions and regulation and mergers and acquisitions. Mr. Kapen has represented many business enterprises and investors in a wide range of corporate and commercial matters and transactions, including entrepreneurs, early stage companies and individual and institutional investors in the negotiation of capital raising transactions and the structuring and funding of venture capital funds.

Farrell Fritz, P.C.

Since **Farrell Fritz** opened its doors on Long Island in 1976, it has been proud to make an enduring contribution to businesses and individuals in the communities it serves. Its attorneys have worked hand-in-hand with leaders of companies of every size and type throughout the New York metropolitan area and beyond. Farrell Fritz's trusted counsel has enabled hundreds of area businesses to grow intelligently, negotiate confidently, resolve disputes efficiently, and meet challenges head on.

[1] Net Worth Standard for Accredited Investors, SEC Release No. 33-9177 (January 25, 2011), available at: **http://www.sec.gov/rules/proposed/2011/33-9177.pdf**.

[2] See Proposing Release at note 31.