BURNS & LEVINSON LLP

SECURITIES LAW UPDATE

January 2012

SEC Adopts New Standards for "Accredited Investor" Status

On Dec. 21, 2011, the Securities and Exchange Commission (the "SEC") amended the regulatory definition of "accredited investors" for individuals as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As noted by the SEC, the accredited investor standards are important because they define those investors deemed to be of sufficient net worth "to 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." The new rules become effective on February 27, 2012.

It is important to note, however, that the substance of the amended rules – that an investor's primary residence must be excluded from the net worth test as to whether that investor is an accredited investor – has been in place under Dodd-Frank since July 20, 2010. The SEC's recent actions were taken to formally amend the regulatory definition and, in doing so, to clarify some issues with regard to the impact of debt (i.e, mortgages) on the net worth test.

The amended rules redefine "accredited investors" for purposes of compliance by issuers with limited private offering exemptions from registration under Rules 504, 505 or 506 of Regulation D, as well as under Section 4(5) of the Securities Act of 1933, as amended.

In doing so, the amended rules provide:

- A new method of calculating net worth that disregards an investor's equity in a primary residence while taking into account any mortgage liability in excess of fair market value;
- A deterrent to investors taking out home equity loans solely to meet accredited investor standards; and
- A grandfathering provision that enables investors to qualify for accredited status in limited situations under the former definition where they held securities and/or derivative rights prior to July 20, 2010, the date of enactment of the Dodd-Frank Act.

The adopted rules are similar but not identical to those publicly proposed by the SEC on January 25, 2011. The SEC made some adjustments to the proposed rules based on public comments, but in order to avoid unnecessary complexity, the SEC declined to adopt any rule defining "primary residence" despite some comments calling for such a definition. "[T]he term 'primary residence' is well understood, and does not require a legal definition. We believe the 'primary residence' has a commonly understood meaning as the home where the person lives most of the time," the SEC concluded.

This update provides an overview of the recent rule changes, but the full text of the SEC Release No. 33-9287 can be found at www.sec.gov/rules/final/2011/33-9287.pdf.

OVERVIEW OF THE AMENDED RULES

The SEC adopted identical definitions for "accredited investors" under both Rule 215, which pertains to Section 4(5) exempt offerings to accredited investors, and Rule 501, which pertains to exempt offerings pursuant to Rules 504, 505, or 506 of Regulation D to accredited investors and to limited numbers of non-accredited investors.

There are two tests as to whether an individual is deemed to be an accredited investor. One is the income test: "Any natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year." This income test has not been changed by the new rules.

The second test is the net worth test: "Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million."

The definition itself has not changed. What has changed is the method for calculating net worth, which now provides that:

- 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 fair market value of the primary residence at the time of sale of securities, shall not 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 sale of securities shall be included as a liability.

In an attempt to deter investors from taking out home equity loans solely to acquire accredited investor status, by converting their home equity into cash or other assets that would be included in the net worth calculation, the new rules also provide that:

- If the amount of such indebtedness [for a home loan or loans] outstanding at the time of 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 [even if the estimated value of the primary residence exceeds the aggregate amount of debt secured by such primary residence].

"This approach will make it more difficult for individuals to manipulate their net worth as calculated under our rules by borrowing against their primary residence shortly before seeking to qualify as an accredited investor, to take advantage of any positive equity in the primary residence," the SEC concluded.

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The new rules also provide for a "grandfathering" provision, which is discussed below under "TRANSITION RULES."

TREATMENT OF MORTGAGE DEBT

The language of the new rules means that in cases where a home is valued higher than the current mortgage, any positive equity is not included as an asset in the net worth test; however, the amount of the mortgage is not included as a liability in calculating net worth. In addition, in cases where a home is valued lower than the current mortgage (i.e., the mortgage is "underwater"), the amount of mortgage debt that exceeds the value of the house is included as a liability in the net worth calculation, whether or not the lender can seek repayment from other assets in default. The SEC explicitly rejected a proposal to give different treatment to investors with non-recourse loans or to investors with loans in states that do not permit personal recourse.

TRANSITION RULES

After review of public comments on the proposed rules, the SEC determined that "limited grandfathering would be appropriate in connection with investors' exercise of certain pre-existing rights to acquire securities." Thus, the final rules contain a provision under which the former accredited investor test will apply to current purchases of securities where:

- Such right to purchase was held by the person on July 20, 2010 (the date of enactment of the Dodd-Frank Act);
- 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.

This right applies to warrants, options and other derivative securities, as well as rights to invest in future rounds of financing, that were acquired by the investor along with the purchase of securities prior to July 20, 2010. For example, if an investor acquired in May 2010 warrants along with a purchase of common stock, and the investor now wants to exercise those warrants, the investor can, if necessary, look back to the May 2010 definition of accredited investor (under which the value of a primary residence was included in the net worth test) to determine if he or she is still accredited and therefore able to exercise the warrant. Similarly, if that same investor has a contractual right based on the May 2010 purchase of common stock to participate in the next round of financing of the company, and the company plans to do its next round of financing now, the investor can utilize the same look-back to see if they are currently deemed to be accredited.

Explanatory Notes:

This update is intended to call your attention to a number of rule changes of possible interest and relevance, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these proposed rule changes or if you want to learn more about our expertise in this area.

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We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

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