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Companies Raising Capital Now Have a Smaller Pool of Investors to Choose From

SEC AMENDS NET WORTH STANDARD FOR ACCREDITED INVESTORS

Following concerns about the housing bubble artificially inflating individuals' net worth and thereby increasing their eligibility to purchase securities in private offerings with less information than they otherwise would be entitled to, Congress revised the definition of "accredited investor" to exclude the value of a person's primary residence in determining if the investor has the requisite net worth. Though this revision took immediate effect under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Securities and Exchange Commission recently revised its rules to provide greater clarity regarding the change.

Under existing SEC rules, companies raising money in private placements to accredited investors can make offers and sales to those investors with much less information and in greater numbers than if they included non-accredited investors. This can greatly increase the speed and efficiency of an offering and therefore many companies raising significant amounts of capital seek to only include accredited investors in their private placements. The rules provide a series of bright line alternative thresholds, any of which can be met, for investors to qualify as accredited. One of these tests is that an investor qualifies as accredited if he or she has a minimum net worth of \$1 million, held individually or together with a spouse. The amended rules change the calculation for this test by reducing an individual's net worth by the value of his or her primary residence.

In addition, the amended rules clarify the impact of mortgages secured by an individual's primary residence on the net worth calculation. Debt secured by a primary residence, up to the estimated fair market value of the primary residence, will not be subtracted as a liability in calculating net worth. Conversely, debt in excess of the fair market value of the primary residence is subtracted as a liability. The SEC does not give guidance on calculating the estimated fair market value, but instead leaves this determination to the discretion of the investors. To address a concern that individuals could artificially inflate their net worth by borrowing against their home equity shortly before participating in an exempt securities offering, the amended rules further provide that if debt secured by a primary residence (1) occurs within 60 days

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of the securities purchase and (2) is unrelated to the acquisition of the primary residence, then the debt must be treated as a liability, even if the value of the debt is less than the property's market value.

The amended rules provide a limited grandfathering provision for certain previously accredited investors who would now no longer qualify, but had preexisting rights to acquire securities. Specifically, the pre-Dodd-Frank net worth standard applies for any individual who, on July 20, 2010, the day before the enactment of the Dodd-Frank Act, (1) had the right to purchase securities, (2) qualified as an accredited investor based on net worth at the time the person acquired such right and (3) held securities of the same issuer (in addition to such purchase right). This provision may preserve certain rights to acquire securities at a future date which were previously bargained-for, such as pre-emptive rights, option rights or rights of first refusal. However, the SEC specifically declined to extend the transition relief to participation in subsequent or "follow-on" investments, where such participation is not based upon a preexisting right.

The SEC is required to review the definition of the term "accredited investor" in its entirety every four years, beginning in July 2014, and to engage in further rulemaking after such review to the extent it deems appropriate.

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To obtain further information about the definition of accredited investor, other SEC rules or private placements generally, please contact the lawyer at Sullivan & Worcester LLP with whom you regularly consult, or any of the lawyers listed above.

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