

**ALERTS**

## **New Net Worth Standard for Accredited Investors**

**January 12, 2012**

On Dec. 21, 2011, the U.S. Securities and Exchange Commission (the “SEC”) adopted amendments to the accredited investor net worth test (as set forth in Rule 501(a)(5) (“Rule 501”) of Regulation D, the private placement safe harbor promulgated under Section 4(2) of the U.S. Securities Act of 1933, as amended (the “Securities Act”). The amendments, which will take effect on Feb. 27, 2012: (1) conform Rule 501 to the modifications made to the net worth test previously effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”);<sup>[1]</sup> (2) add a new provision that requires an investor to include in the calculation of net worth certain incremental debt secured by the primary residence (which would not be included if the net worth calculation were made in accordance with the net worth standard effected by Dodd-Frank); and (3) add a new “grandfather” provision that allows certain investors to continue to use the pre-Dodd Frank net worth test.<sup>[2]</sup>

Offers and sales of securities by private funds are typically made under Rule 506 of Regulation D as a “safe harbor” from registration under the Securities Act. Purchasers of securities in such offerings generally must be “accredited investors,” as defined under Rule 501(a). An individual investor may meet the definition of accredited investor by satisfying the net worth test under Rule 501, which defines an accredited investor as “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000.” Before Dodd-Frank amended the net worth test, net worth (which is not defined in the Securities Act or any rule promulgated thereunder) was

commonly understood to mean the excess of total assets over total liabilities, including the investor's primary residence.

Consistent with the modifications effected by Dodd-Frank, and subsequent guidance issued by the SEC,[3] amended Rule 501 excludes from net worth an investor's primary residence and debt that is secured by the investor's primary residence up to the fair market value of the primary residence. However, amended Rule 501 includes a new provision that requires an investor to include as a liability any increase in the amount of debt secured by the investor's primary residence incurred within 60 days before the investor enters into the transaction for which it is making the accredited investor representation. This 60-day "look-back" is intended to address potential incentives for investors to incur debt secured by a primary residence for the purpose of artificially inflating their net worth. Finally, amended Rule 501 also includes a "grandfather" provision that allows an investor to use the pre-Dodd-Frank net worth test if: (1) the investor purchases securities in accordance with a right to purchase such securities (e.g., a statutory right, a right arising under an entity's constituent documents or a contractual right) that was held by the investor on July 20, 2010; (2) the investor qualified as an accredited investor on the basis of net worth at the time the investor acquired such right; and (3) the investor held securities of the same issuer, other than such right, on July 20, 2010.

The amendments to Rule 501 become effective on Feb. 27, 2012, and the new net worth standard applies only to offers and sales of securities occurring on or after such date. Accordingly, investors making subscriptions for interests in private investment funds after Feb. 27, 2012, must certify that they are accredited investors under the new standard to the extent the offer and sale is made under Regulation D and the investor is relying on the net worth standard. Specifically, managers will need to update their subscription agreements to ensure that any new investor or current investor that is making an initial or additional subscription and that relies, directly or indirectly, on the net worth standard, certifies its status as an accredited investor under the new net worth test. Such investors may include individual investors, entity investors, IRAs, Keogh Plans or other self-directed defined contribution plans, and trusts, whether investing in a domestic or offshore fund. Funds do not need to obtain new certifications from existing investors, unless the existing investor is making an additional subscription.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Upon the enactment of Dodd-Frank on July 21, 2010, the accredited investor standard was modified so that a natural person is no longer permitted to include the value of his or her primary residence in determining whether such person meets the \$1 million net worth test.

[2] See *Net Worth Standard for Accredited Investors*, Release No. 33-9287 (Dec. 21, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-12-29/pdf/2011-33333.pdf>.

[3] The SEC issued guidance on July 23, 2010, providing that in calculating net worth, the investor may exclude the amount of any indebtedness secured by the primary residence, up to the fair market value of the primary residence (indebtedness in excess of the fair market value should be considered a liability and deducted from the investor's net worth).

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