



INVESTMENT FUNDS UPDATE

SEC Finalizes Net Worth Standard for Natural Person Accredited Investors

On December 21, 2011, the Securities and Exchange Commission (the “SEC”) adopted amendments (the “Amendments”)¹ to the “accredited investor” standard included in rules under the Securities Act of 1933 (the “Securities Act”).² The Amendments implement of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”), which required the SEC to adjust the “accredited investor” net worth standard that applies to natural persons individually, or jointly with their spouse, to “more than \$1,000,000... excluding the value of the primary residence.”³ The Amendments clarify how to account for indebtedness secured by a natural person’s primary residence and provide for limited transitional relief.

Under the Amendments and the Dodd Frank Act, net worth for purposes of the “accredited investor” test excludes a natural person’s primary residence as an asset as well as excludes indebtedness secured by such primary residence except that either (i) it is in excess of the fair market value of the primary residence; or (ii) has increased in the 60 days prior to the relevant date of the purchase of the security other than as a result of the acquisition of the primary residence. The first part takes into account the amount by which a prospective investor is “underwater”. The second part is meant (*e.g.*, a second mortgage or home equity loan) to prevent investors from “gaming” the net worth calculation by converting positive equity, which would not count towards net worth, into assets that would count. The fair market value of the primary residence and the amount of the corresponding indebtedness are determined as of the date of the sale of securities (*i.e.*, the date on which a subscription is accepted by a private fund). The adopting release notes that a natural person may estimate the fair market value of the primary residence and need not obtain a third party opinion or appraisal to make such determination.

The Amendments include a limited transition rule to permit a natural person to continue to calculate his or her net worth under the pre-July 21, 2010 accredited investor standard (*i.e.* taking into consideration the value of a primary residence). The transition rule requires that such natural person: (i) be purchasing securities pursuant to a right to purchase such securities that was held on July 20, 2010; (ii) was an accredited investor on the basis of his or her net

¹ The full text of the adopting release may be found at <http://sec.gov/rules/final/2011/33-9287.pdf>.

² The amendments impact Rule 144(a)(3)(viii), 155(a), 215, 501(a)(5), 501(e)(1)(i) and Rule 500(a)(1) under the Securities Act; Form D under the Securities Act; Rule 17j-1(a)(8) under the Investment Company Act of 1940; and Rule 204A-1(e)(7) under the Investment Advisers Act of 1940.

³ Previously, the standard required a minimum net worth of more than \$1,000,000, but permitted the primary residence to be included in calculating net worth.

worth at the time the person acquired such right; and (iii) held securities of the same issuer, other than such right, on July 20, 2010. This transition rule is likely to be of limited value to most private funds.

The Amendments, as adopted, could result in a net worth calculation that is lower than the calculation under prior standards. For example, the Amendments do not distinguish between recourse and non-recourse debt for purposes of determining whether debt should reduce net worth. Anticipating that the SEC would agree with arguments made in comment letters from the American Bar Association and others, the subscription documents for many private funds only require a natural person to reduce their net worth by the amount of “underwater” debt if the lender had recourse to the borrower’s other assets. Additionally, while the SEC’s proposing release solicited comment on whether the Amendments should contain a timing provision to prevent artificial inflation of net worth, the 60-day standard was not finalized until the adoption of the Amendments and has, therefore, not been included in subscription documents.

Private fund managers should review their subscription documents and update the relevant provisions prior to February 27, 2012 to reflect the impact of the Amendments. Included below is suggested language to be included for the natural person net worth prong of the “accredited investor” standard.

Suggested Language

You are a natural person whose individual net worth, or joint net worth with your spouse, exceeds \$1,000,000 as of the subscription date. “Net worth” for this purpose means the fair market value of your total assets less your total liabilities; provided, that: (i) you must exclude the value of your primary residence as an asset; and (ii) you may generally exclude the amount of indebtedness secured by your primary residence as a liability *except* that you must deduct as liabilities (A) the amount by which such indebtedness exceeds the fair market value of your primary residence; and (B) the amount of any such indebtedness incurred within the 60 days preceding the subscription date (other than as a result of the acquisition of your primary residence).”

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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