

## SEC Adopts Net Worth Standard For Accredited Investors Under Regulation D

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Effective July 21, 2010, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act modified the \$1 million net worth test for qualifying as an “accredited investor” under Regulation D to exclude for the first time the value of a person’s primary residence.<sup>1</sup> The Securities and Exchange Commission has now amended its rules to conform them to this modification and to clarify the treatment of debt secured by an investor’s primary residence for purposes of the net worth calculation.<sup>2</sup>

The amended net worth standard will be effective February 27, 2012, and as discussed in greater detail below, issuers will likely need to revise investor questionnaires for any Regulation D sales on and after that date (including sales to existing investors in funds with continuous offerings).

Regulation D provides a safe harbor exemption from registration under the Securities Act of 1933, as amended, for private placements. Many issuers, including hedge funds and private equity funds, rely on Regulation D for their offerings. Typically, Regulation D offerings are made only to investors that qualify as accredited investors in order to be exempt from additional disclosure requirements that apply when offerings include non-accredited investors.

In addition to conforming Regulation D to the Dodd-Frank Act to provide that the value of an individual’s primary residence is not counted as an asset for purposes of calculating net worth, Rule 501(a)(5) now also provides that indebtedness secured by a person’s primary residence, up to the estimated fair market value of the primary residence, is not treated as a liability. Any such secured indebtedness in excess of the property’s esti-

mated fair market value must be treated as a liability for purposes of calculating net worth.

The net worth test adopted by the SEC also requires that any borrowings incurred by an investor in the 60 days preceding the purchase of securities in the exempt offering that are secured by the primary residence but are not used to purchase it must be counted as a liability in the net worth calculation. The SEC explained that this new provision is intended to prevent manipulation of the net worth standard by eliminating the ability of individuals to artificially inflate net worth via home equity loans shortly before participating in an exempt securities offering.

Citing the fact that issuers had been able to cope with exclusion of the value of an investor’s primary residence from the net worth test for accredited investors since it went into effect on July 21, 2010, the SEC determined not to allow existing investors to use the prior net worth test, except for one narrow exception set forth as paragraph (2) of the new rule included in the footnote below.<sup>3</sup>

Since there is no general grandfathering of current investors, and Regulation D requires that accredited investor status be determined at the time of investment, the issuer of any Regulation D offering currently in process should determine which, if any, potential investors (and any existing investors that elect to make additional investments) are relying exclusively upon the \$1 million net worth test and should have such investors confirm that their calculation of net worth would meet the new requirements. Although many issuers have already modified their subscription documents to require investors to calculate net worth without including as an asset the value of the investor’s primary residence and not to treat as a liability any mortgage on the primary residence up to the value of the home, after effectiveness of the new provisions any calculation of the net worth test should also include as a liability any increase in debt

secured by the investor’s primary residence (which was not incurred in connection with the purchase of the home) in the 60 days preceding the purchase of securities in the Regulation D offering.

<sup>1</sup> Section 413(a) of the Dodd-Frank Act required the SEC to periodically adjust upward any net worth standard for an accredited investor, but for the first four years the net worth standard is \$1 million excluding the value of the primary residence. Please also see our previous client alert Immediate Change in Accredited Investor Requirements in Dodd-Frank Act, July 21, 2010 is available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/3431/Immediate%20Change%20In%20Accredited%20Investor%20Requirements.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3431/Immediate%20Change%20In%20Accredited%20Investor%20Requirements.pdf).

<sup>2</sup> SEC Release 33-9287 (Dec. 21, 2011) <http://www.sec.gov/rules/final/2011/33-9287.pdf>. 76 Fed. Reg. 81, 793 (Dec. 29, 2011). The \$1 million net worth category of accredited investor is found in Rule 501(a)(5) of Regulation D.

<sup>3</sup> Specifically, the \$1 million net worth category of the accredited investor definition in Regulation D, Rule 501(a)(5), has been modified to provide that an accredited investor includes:

Any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000.

(1) Except as provided in paragraph (2) of this section, for purposes of calculating net worth under this paragraph:

(i) The person’s primary residence shall not be included as an asset;

(ii) Indebtedness that is secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of the 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); and

(iii) 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 the sale of securities shall be included as a liability.

(2) Paragraph (1) of this section will not apply to any calculation of a person’s net worth made in connection with a purchase of securities in accordance with a right to purchase such securities, provided that:

(i) such right was held by the person on July 20, 2010;

(ii) the person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and

(iii) the person held securities of the same issuer, other than such right, on July 20, 2010.

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