

SEC Adopts “Accredited Investor” Definition

Our previous [alert](#) dated December 19, 2011, described proposed changes to the “accredited investor” standards. On December 29, 2011, the Securities and Exchange Commission (the “SEC”) adopted final rules implementing these proposed changes. The primary differences between the proposed and final rules are described below.

1) *Generally.* As set forth in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”), the definition of “accredited investor” continues to provide for a net worth threshold for natural persons of \$1,000,000; however, for purposes of the threshold the net worth calculation excludes the person’s primary residence.

2) *Indebtedness.* Under the final rules, the net worth calculation does not include indebtedness secured by the person’s primary residence up to the estimated fair market value of the primary residence (except for indebtedness incurred in the 60 days before the time of sale of securities, as further described below). Indebtedness secured by the person’s primary residence *in excess* of the estimated fair market value of the primary residence (*i.e.*, an underwater mortgage), however, is included in the net worth calculation (*i.e.*, such indebtedness reduces a person’s net worth for this purpose).

3) *Increase in Mortgage Debt in the 60 Days Before Sale of Securities.* The final rules contain a new provision that would include in the net worth calculation any increase in the amount of debt secured by a primary residence (other than as a result of the acquisition of the primary residence) in the 60 days before the time of sale of securities. This new provision is intended to prevent investors from artificially inflating their net worth by taking on additional debt secured by their primary residence, thereby effectively converting their home equity, which is otherwise excluded from the net worth calculation, into an asset that would be included in the net worth calculation.

4) *Grandfathering Provision.* The final rules contain a limited grandfathering provision with respect to certain pre-existing rights to acquire securities (*e.g.*, rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible instrument) so long as (i) the right was held by the person on July 20, 2010 (immediately prior to enactment of the Dodd-Frank Act); (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. This limited grandfathering provision will likely not apply in the hedge fund or private fund context.

5) *Effective Date.* While the final rules described above in sections 2, 3 and 4 are effective February 27, 2012, the exclusion of a natural person’s primary residence from the net worth calculation, described in section 1, became effective on July 21, 2010, upon enactment of the Dodd-Frank Act.

6) *Other Regulation D News.* On January 9, 2012, the Managed Funds Association (“MFA”) petitioned the SEC to amend Regulation D to permit the general solicitation of investors by private funds. We will continue to monitor the SEC’s consideration of this petition.

Hedge fund and other private fund managers may wish to update their subscription agreements to reflect the changes to the “accredited investor” definition described above. Please contact your usual Ropes & Gray adviser with any questions.