

## Investment Funds Alert

### Immediate Action Needed to Amend Subscription Agreement Forms After Definition of Accredited Investor Changed for Individuals

July 26, 2010

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On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was signed into law by President Obama. Section 413 of the Dodd-Frank Act—which takes effect immediately—modifies the net worth standard for natural persons (individuals) in the definition of “accredited investor,” as defined under Rule 501(a)(5) of Regulation D under the Securities Act of 1933 (the “Securities Act”). Private fund issuers **must** amend their subscription agreements to reflect this revised definition for any subscriptions accepted after July 21, 2010.

Alternative investment funds, including hedge and private equity funds, depend on the private placement exemption to avoid registration of their offerings under the Securities Act and, also, to avoid registration of the funds under the Investment Company Act of 1940. Most alternative investment funds pursue the private placement exemption through compliance with Regulation D and generally require all investors to be “accredited investors” as defined in Regulation D. Individual investors fall within that definition, among other ways, if they have a net worth of at least \$1 million. Prior to enactment of the Dodd-Frank Act, individuals could count their principal residence toward this \$1 million net worth requirement. Pursuant to Section 413 of the Dodd-Frank Act, individuals are no longer able to include the value of their primary residence toward the \$1 million requirement to be an accredited investor. The SEC staff has indicated that an individual need not deduct from his or her net worth the amount of mortgage debt secured by an excluded primary residence, except to the extent that the amount of the mortgage liability exceeds the fair value of the residence. The alternative test for an individual to be an accredited investor, based on the net income of the individual or individual and spouse and other provisions of the accredited investor definition in Regulation D, remains unchanged.

The Dodd-Frank Act provides that the Securities and Exchange Commission (SEC) may not modify the net worth requirement during the four years following the enactment of the Dodd-Frank Act. However, once this four-year period has passed, the SEC is tasked with reviewing, at least once every four years, the accredited investor definition as it applies to individuals, including both the net worth and income tests, and making adjustments to the accredited investor definition as the SEC deems appropriate.

The Dodd-Frank Act does not include a grandfathering provision for application of the revised net worth requirement to existing offerings. Thus, private fund issuers should **immediately** update their subscription documents for ongoing and future private offerings to reflect the exclusion of an individual’s primary residence for purposes of determining accredited investor status. Issuers should also require existing investors who are individuals to represent that they meet this updated net worth standard before accepting



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additional subscriptions. No action is required with respect to existing investors who are not making additional investments. We will update you if and when the SEC provides any guidance with respect to the treatment of mortgage debt.

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