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ACCREDITED INVESTORS

Modification of Definition of Accredited Investor Requires Hedge Funds to Revise Their Subscription Agreements

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To invest in domestic hedge funds, a natural person must be an "accredited investor." The term "accredited investor" is defined Rule 501 of Regulation D, the private placement safe harbor promulgated under Section 4(2) of the Securities Act of 1933, as amended. If a natural person satisfies either of two tests in Rule 501, that person is an "accredited investor." Those tests are the income test and the net worth test. Under the income test, a natural person is an accredited investor if he or she had individual income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of the those years, with a reasonable expectation of reaching the same income level in the current year. Under the net worth test, a natural person is an accredited investor if he or she has a net worth of at least $1 million.

Dodd-Frank did not modify the income test, but did modify the net worth test. Specifically, Dodd-Frank modified the net worth test by providing that a natural person may no longer include the value of his or her primary residence in determining whether he or she has a net worth of at least $1 million. (Prior to enactment of Dodd-Frank, natural persons were allowed to include the value of the primary residence in making the net worth calculation.) On July 23, 2010, the SEC issued guidance providing that in calculating net worth, a natural person may exclude the amount of any indebtedness secured by his or her primary residence up to the fair market value of the primary residence, but must include (that is, subtract from) net worth any indebtedness secured by his or her primary residence in excess of the fair market value of the primary residence.

In short:

- Fair market value of primary residence: not included in calculation of net worth.
- Mortgage debt on primary residence up to fair market value of primary residence: does not reduce net worth.
- Mortgage debt on primary residence in excess of fair market value of primary

residence: reduces net worth.

The new accredited investor standard applies to new investors and new subscriptions by current investors, but does not apply to existing investments by current investors. That is, new investors and current investors making new subscriptions will have to certify that they meet the new net worth test, if they are relying on it, but existing investors will not have to re-certify that they meet the new net worth test, even if they invested in reliance on it. Types of investors that may have to make such certifications include natural persons, certain entities, IRAs, Keogh Plans, certain other self-directed defined contribution plans, and certain trusts.

Dodd-Frank provides that the SEC may not modify the net worth requirement during the four years following enactment of the Act, but requires the SEC to review, at least once every four years thereafter, the net worth and incomes tests, and to make adjustments to either test as the agency deems appropriate.

Most hedge funds managers likely will have to revise their subscription documents, and in some cases other documents (e.g., private placement memoranda) to reflect the revised definition of accredited investor. However, this revision is likely to have only a muted impact on the hedge fund investor base, for two primary reasons. First, institutions comprise a far more significant proportion of assets invested in hedge funds than do individuals. According to Preqin, a data provider that tracks institutional investments in hedge and private equity funds, since 2007, institutional assets in hedge funds have increased by 39 percent. In 2007 institutional capital represented around 40 to 45 percent of the total assets in hedge funds and today institutional capital represents about 70 percent. Accordingly, in a period where hedge fund assets have fallen, mainly as a result of redemptions by high net worth individuals, the total amount of institutional capital invested in hedge funds has increased. Therefore, institutions have increase their total share of assets invested in hedge funds, and their assets in hedge funds relative to individuals.

Second, most natural persons that invest in hedge funds are not close to the net worth line – they are comfortably beyond it. Including or excluding the fair market value of the primary residences of such persons often will not make or break the net worth determination.
