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A Revised Net Worth Standard for Accredited Investors

The Dodd-Frank Act directs the SEC to update its definition of “accredited investor” to exclude the value of a person’s primary residence. The SEC now has proposed rules to implement this provision, which is not as straightforward as it first appears.

By Kenneth Muller, Andrew Thorpe, Sean Byrne, and Seth Chertok

On July 21, 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).¹ It requires the U.S. Securities and Exchange Commission (Commission) to update the decades-old “accredited investor” standard appearing in Regulation D and Section 4(5) under the Securities Act of 1933 (Securities Act) in the manner described below. In general, prior to the Dodd-Frank Act, an “accredited investor” was defined in Rule 501 (with respect to Regulation D) and Rule 215 (with respect to Section 4(5)) as (1) any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1 million, (2) any natural

person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or (3) any entity not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5 million.

The Dodd-Frank Act requires the Commission to adjust any net worth standard for an “accredited investor” so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than \$1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person.² Furthermore, until July 21, 2014, any net worth standard will be \$1,000,000, excluding the value of the primary residence of such natural person.³

The Dodd-Frank Act gives the Commission the authority to determine whether the requirements of the term “accredited investor” as such term applies to natural persons, excluding the exclusion of the primary residence requirement relating to the net worth requirement, should be adjusted for the protection of investors, in the public interest and in light of the economy.⁴ The Dodd-Frank Act specifically confers authority upon the Commission to make such adjustments by notice and comment rulemaking.

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Moreover, under the Dodd-Frank Act, the Commission has the obligation to conduct subsequent reviews every four years of the term “accredited investors” as such term applies to natural persons in order to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy.⁵ The Dodd-Frank Act specifically confers authority upon the Commission to make such adjustments by notice and comment rulemaking.

Finally, the Dodd-Frank Act requires the U.S. Comptroller General to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.⁶ Its report on the results of such study must be submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, no later than July 21, 2013.⁷

The “accredited investor” standard is important for several reasons. First, Regulation D is the most commonly relied upon exemption for issuers conducting limited offerings and private placements of securities. A significant component of Regulation D that investors be “accredited investors.” In addition, the two major Investment Company Act of 1940 exemptions, Section 3(c)(1) and Section 3(c)(7), rely on a fund’s ability to use the private placement exemptions under Section 4(2) and the rules promulgated thereunder. Typically, these securities were issued under Rule 506 promulgated under Regulation D thereunder. Finally, the term “accredited investors” also appears in Section 4(5) of the Securities Act, which is another type of limited offering exemption.

On January 25, 2011, in Securities Act Release No. 33-9177 (Release), the Commission proposed amendments to the accredited investor standards in its rules under the Securities Act to reflect the requirements of Section 413(a) of the

Dodd-Frank Act.⁸ The Commission also proposed technical amendments to Form D and a number of rules thereunder to conform them to the language of Section 413(a) and to correct cross-references to former Section 4(6) of the Securities Act, which was renumbered Section 4(5) by Section 944 of the Dodd-Frank Act.

“Accredited Investor” Proposed Changes

Calculation of Accredited Investor “Net Worth”

In calculating accredited investor net worth, the Commission first noted that the term “net worth” was undefined. The Commission first proposed to define “net worth” under Rule 501 and Rule 215 to give effect to its conventional meaning, *i.e.*, the difference between the value of a person’s assets and the value of the person’s liabilities. Note that in this article we use the term accredited investor net worth differently from net worth, since the Commission has proposed using a modified net worth standard when calculating net worth for purposes of determining if a person is an “accredited investor” in the Securities Act and the rules promulgated thereunder.

Prior to the Dodd-Frank Act, accredited investor net worth was defined as individual net worth, or joint net worth with that person’s spouse, at the time of purchase exceeding \$1 million. As required by the Dodd-Frank Act, the proposed rules would define accredited investor net worth as individual net worth, or joint net worth with that person’s spouse, at the time of purchase exceeding \$1 million, “excluding the value of the primary residence of such natural person.” The Commission proposes to expand on the Dodd-Frank Act statutory language by adding “subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property.” Thus, under the Commission’s proposed formulation, accredited investor net worth would be defined as individual net worth, or joint net worth with that person’s

spouse, at the time of purchase, exceeding \$1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property.

The Commission stated in the Release that its purpose was to ensure that net worth is calculated by excluding only the investor's net equity in the primary residence, that is, the amount by which the fair market value of the home exceeds the mortgage. Thus, under the Commission's proposal, accredited investor net worth would effectively be calculated under the following formula:

$$\text{Accredited Investor Net Worth} = \text{Net Worth (Total Assets - Total Liabilities)} - \text{Primary Residence Net Equity (Value of Residence - Debt Secured by Residence up to Value of Residence)}$$

The Commission endorsed the above proposed approach because it believed that such approach will reduce the accredited investor net worth measure by the amount that the primary residence contributed to the investor's net worth before enactment of Section 413(a) of the Dodd-Frank Act. The following example illustrates this approach:

Assume that an investor's only asset is a \$1.2 million residence with an \$800,000 mortgage, and that its residence is therefore not underwater (*i.e.*, it has a fair market value that is greater than or equal to the amount outstanding on its mortgage). Prior to the Dodd-Frank Act, the investor would have had an accredited investor net worth of \$400,000, with the full amount being contributed by the residence. Under the proposed rules, the investor's accredited investor net worth would be zero $((\$1,200,000 - \$800,000) - (\$1,200,000 - \$800,000) = \$0)$. In this scenario, the primary

residence previously contributed \$400,000 to the accredited investor net worth, and following the Commission's proposed rules, the accredited investor net worth would be reduced by \$400,000.

Assume that an investor has a \$1.5 million mortgage, a \$1.2 million residence and \$400,000 in cash, and that its residence is therefore underwater (*i.e.*, has a fair market value that is less than the amount outstanding on its mortgage). Prior to the Dodd-Frank Act, the investor would have had an accredited investor net worth of \$100,000, with nothing being contributed by the residence, since the mortgage exceeds the value of the residence. Thus, the \$100,000 in net worth would be contributed by the cash. Under the Commission's interpretation, its accredited investor net worth would be \$100,000 $((\$1,600,000 - \$1,500,000) - (\$1,200,000 - \$1,200,000) = \$100,000)$. In this scenario, the primary residence previously contributed zero to the accredited investor net worth, and following the Commission's proposed rules, the accredited investor net worth would therefore be reduced by zero. This is evidenced by the fact that the accredited investor net worth in either scenario is \$100,000. Note that if the Commission permitted debt secured by the property in excess of the fair market value to be netted out from Primary Residence Net Equity, the accredited investor net worth amount of the investor would increase, in relation to the amount prior to the enactment of Section 413(a), by the underwater amount, which the Commission is aiming to avoid.

Another issue under the proposed rules to consider is the effect of debt secured by the residence on accredited investor net worth. Under the Commission's approach, if the primary residence were not underwater, the debt secured by the property effectively would have no impact

on accredited investor net worth. This can be illustrated as follows. Suppose that an investor has \$3 million in assets, \$1 million in liabilities, a \$1.2 million residence and \$800,000 in debt secured by the primary residence. Its accredited investor net worth would be \$1,600,000 $((\$3,000,000 - \$1,000,000) - (\$1,200,000 - \$800,000) = \$1,600,000)$. If there were no mortgage, its accredited investor net worth would remain \$1,600,000 $((\$3,000,000 - \$200,000) - (\$1,200,000) = \$1,600,000)$.

If an investor were to increase the debt secured by the residence but not to the point where the residence was underwater, the investor could increase its accredited investor net worth without increasing its actual net worth. This can be illustrated as follows. Suppose that an investor has \$3 million in assets and \$1.2 million in liabilities, including a \$1.2 million residence and \$1 million in debt secured by the primary residence. Its accredited investor net worth would be \$1,600,000 $((\$3,000,000 - \$1,200,000) - (\$1,200,000 - \$1,000,000) = \$1,600,000)$. If that investor were to borrow \$100,000 against its residence and invest the proceeds in Treasury bills, that investor's accredited investor net worth would increase \$100,000 to \$1,700,000 $((\$3,100,000 - \$1,300,000) - (\$1,200,000 - \$1,100,000) = \$1,700,000)$. This ability for an investor to increase its "net worth" by borrowing against its residence is of concern to the North American Securities Administrators Association, as discussed below.

If an investor's primary residence is underwater, then that investor's accredited investor net worth under the Dodd-Frank Act will be the same as it was before the Dodd-Frank Act. This is because the reduction in the investor's assets (the value of the primary residence) will always be offset by an equal reduction in the investor's liabilities (the amount of mortgage debt up to the value of the primary residence). Because any excess mortgage debt is already included as a liability in the pre-Dodd-Frank Act accredited investor net worth calculations,

it does not matter how much excess mortgage debt there is, the underwater investor's new accredited investor net worth will always equal its pre-Dodd-Frank Act accredited investor net worth.

Alternative Measures of Accredited Investor Net Worth

In the Release, the Commission discussed whether an investor's net equity in its primary residence was the correct value to subtract from net worth or whether another value better implemented Congress's intent.

First, the Commission considered excluding the fair market value of the residence without netting out the secured indebtedness. Under this alternative, accredited investor net worth would effectively be calculated under the following formula:

$$\text{Accredited Investor Net Worth} = \text{Net Worth (Total Assets - Total Liabilities) - Value of Primary Residence}$$

Assume that an investor has a \$1.2 million residence and an \$800,000 mortgage, and that its residence is therefore not underwater. Prior to the Dodd-Frank Act, it would have an accredited investor net worth of \$400,000, with the full amount being contributed by the residence. Under this alternative interpretation, its accredited investor net worth would be - \$800,000 $((\$1,200,000 - \$800,000) - (\$1,200,000) = \$-800,000)$. The Commission noted that this approach would not accord with the manner in which net worth was determined before enactment of Section 413(a) of the Dodd-Frank Act and would make it even more difficult for investors to qualify as "accredited investors." The Commission discussed data from a 2007 study by the Federal Reserve demonstrating that under the accredited investor standard before the Dodd-Frank Act, 9.04 percent of U.S. households qualified as accredited investors. Under the Commission's proposed rule, 6.55 percent of U.S. households would qualify. Under

this alternative approach, only 5.91 percent of U.S. households would qualify.

Second, the Commission considered excluding from accredited investor net worth all indebtedness secured by the primary residence, even in underwater situations. Under this alternative, accredited investor net worth would effectively be calculated under the following formula:

$$\text{Accredited Investor Net Worth} = \text{Net Worth (Total Assets - Total Liabilities) - Net Economic Exposure to Residence (Value of Residence - Debt Secured by Residence)}$$

While this formula reflects the economic reality that an investor does not bear the burden of non-recourse secured debt that is in excess of the value of the collateral (*i.e.*, an investor can surrender the collateral and is not liable for any remaining non-recourse debt that was secured by that collateral), it is inconsistent with how secured debt is generally treated in accredited investor net worth calculations. Furthermore, the Commission noted that this approach would have the effect of increasing the net worth of an investor with an underwater mortgage, which the Commission believes to be inconsistent with Congress's intent.

Definition of "Primary Residence"

The Commission did not propose explicitly to define "primary residence." The Commission stated that issuers and investors should be able to use the commonly understood meaning of "primary residence"—the home where a person lives most of the time. The Commission noted that if additional analysis is needed under complex or unusual circumstances, helpful guidance may be found in rules that apply in other contexts, such as income tax rules and rules that apply when acquiring a mortgage loan for a primary residence, which often bears a lower interest rate than other mortgage loans.

Proceeds of Debt Secured by Primary Residence Incurred to Invest in Securities

The Release notes that the North American Securities Administrators Association has recommended that the Commission not permit the exclusion of debt secured by a primary residence from the calculation of net worth if proceeds of the debt are used to invest in securities. The concern would be that this debt would generally increase accredited investor net worth. While the Commission currently believes that such a change would add unneeded complexity to the "accredited investor" definition, the Commission did solicit comments on whether the proposed amendments should contain a timing provision in order to prevent investors from inflating their net worth by purchasing assets with the proceeds of indebtedness secured by their homes with the intent to qualify as accredited investors.

Transition Rules

The Commission generally did not propose any transition rules. However, it sought comment on whether some transition and other rules might be appropriate to facilitate subsequent investments by an investor who previously qualified as accredited but was disqualified by the change effected by the Dodd-Frank Act.

Conclusion

The SEC has proposed relying upon the following formula in calculating accredited investor net worth:

$$\text{Accredited Investor Net Worth} = \text{Net Worth (Total Assets - Total Liabilities) - Primary Residence Net Equity (Value of Residence - Debt Secured by Residence up to Value of Residence)}$$

This formula will help ensure that the net equity of the residence is excluded, while preventing situations where underwater residences

could inflate net worth. This formula also decreases accredited investor net worth by the portion of net worth that prior to the Dodd-Frank Act would have been attributable to the residence.

NOTES

1. Public Law 111–203, 124 Stat. 1376.

2. Dodd-Frank Act, Section 413.

3. Dodd-Frank Act, Section 413.

4. Dodd-Frank Act, Section 413.

5. Dodd-Frank Act, Section 413.

6. Dodd-Frank Act, Section 415.

7. Dodd-Frank Act, Section 412.

8. “Net Worth for Accredited Investors,” Release No. 33-9177 (Jan. 25, 2011) [76 Fed. Reg. 5307].

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