Securities and Exchange Commission

Proposed Rule
Net Worth Standard for Accredited Investors
File No. S7-04-11, RIN 3235-AK90

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I. Introduction

I welcome this opportunity to submit comment in response to the Securities and Exchange Commission's (the "Commission") proposed amendments to accredited investor standards in rules set forth under the Securities Act of 1933. These amendments, found in File No. S7-04-11, are set forth to reflect the requirements of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). I thank the Commission for providing me the opportunity to comment on the proposed amendments on the calculation of net worth for the determination of accredited investor status.

I am a third year Law and Masters of Business Administration student at Villanova University School of Law. I write as a concerned citizen and investor, who has studied securities law and regulation for several years. In addition to my academic interest in this area, I have also worked for the Commission in the course of my time in graduate school. During the summer of 2010, I served as a Research Specialist in the Commission Enforcement Division's Philadelphia Regional Office ("PLRO"). Also, I continued my stay with the PLRO through the fall 2010 semester as a student extern. I hope my educational background and work experience will provide for a useful comment in scrutinizing the ambiguities of Proposed Rule S7-04-11.

To facilitate the Commission's consideration of my comment, I will provide a summary of my comment, briefly describe the background of the Commission and its statutory framework, and explain the reasoning underlying my comment in regards to each issue upon which the Commission seeks comment.

II. Summary of Comment

I am commenting in favor of the Commission proposed amendments to accredited Investor standards to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the $1 million threshold. Although this change was effective upon enactment of the Dodd-Frank Act, the Commission is seeking thoughtful comment on the best implementations of the proposed amendment. The Commission seeks perspective from interested participants to clarify several issues including:

- the precise meaning of terms within the proposed amendment, such as primary residence, net worth, and fair market value;
- the treatment of any indebtedness secured by the residence in the net worth calculation;
- the timing of when net worth calculations are to be made; and
- special provisions for existing exempted investors who no longer qualify as accredited.

Based on the need to clarify these ambiguities under the proposed rule and the Commission's mandate to continually review the accredited investor standard, I welcome the opportunity to provide additional comment to this proposed rule. Although the impact of accredited investor status extends into other areas of private placement offerings, the scope of this comment is limited to the amendment's impact of Regulation D ("Reg D"). The vast majority of private and limited offerings rely on the Reg D exemptions.

In writing in favor of this proposed amendment, I note the countervailing interests the Commission faces. The Commission is tasked with balancing adequate protections for investors, who may be unable to bear the loss of undue risks, with facilitating capital formation in domestic markets in this fragile economic era. As the Commission explained in the Notice of Proposed Rulemaking, I agree with the Commission assertion that its approach to exclude debt secured by a primary residence up to the fair market value of the property would result in a smaller reduction in the pool of accredited investors than other alternative interpretations. In light of these considerations, I believe this proposed rule strikes the proper balance in weeding out vulnerable investors without stifling economic growth, especially for small businesses.

III. Background

The U.S. Securities and Exchange Commission holds the primary responsibility for enforcing the federal securities laws and regulating the securities industry in the United States. The Commission enforces existing regulations and promulgates new rules in light of various considerations including: protecting investors, facilitating capital formation, ensuring the global competitiveness of U.S. markets, and monitoring the impact of technology.

Within the Commission, the Division of Corporate Finance oversees the disclosures made by public companies when offering investment opportunities, as well as the registration of transactions, such as mergers and acquisitions. The proposed amendments to accredited investor standards are pertinent to this Division, as it affects some issuer exemptions from the requirement of registering securities offerings. These exemptions are primarily found in the limited offerings exemptions available under Reg D.

Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Reg D contains three rules providing exemptions from the registration requirements, allowing some issuers to offer and sell their securities without having to register the securities with the Commission.[1] Reg D was promulgated in an effort to provide an integrated and coherent set of exemptions, and to ease the registration burdens on small issuers. Two rules set forth under Reg D, Rules 505 and 506, are affected by the amendment to net worth standards created by the Dodd-Frank Act.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted to promote the financial stability of the United States by improving accountability and transparency in the financial system, and to protect consumers from abusive financial services practices. The SEC is responsible for implementing the series of regulatory initiatives required under Dodd-Frank Act.

Among such Dodd-Frank reforms, Section 413(a) of the Act alters the definition of an accredited investor's net worth to exclude the value of the investor's primary residence for the purposes of determining accredited status. Section 413(a) also requires the SEC to revise current Securities Act rules to reflect this new standard. Further, the Commission must undertake a review of the definition of accredited investor "in its entirety" every four years, beginning in the year 2014. Proposed Rule S7-04-11 would set the same standard for accreditation for both Rule 501 (under Reg D) and Rule 215 under the Securities Act of 1933.

The accredited investor status plays a significant role in determining the affirmative disclosure requirements placed on an issuer. An issuer offering securities to accredited investors does not face the same obligations on disclosure as an issuer selling to unsophisticated investors. Further, Rule 505 and 506 each limit the availability of the exemption to offerings in which there are no more than 35 purchasers; accredited investors, however, are not included when computing the number of purchasers. While Rule 501(a) defines "accredited investor" to include a variety of investor classes, including: financial institutions, pension plans, venture capital firms, organizations of a certain size, and insiders of the issuer; this proposed rule deals with only one class of accredited investor: *Natural Persons with Wealth or Income Exceeding Threshold Standards*.

The amendments would implement Section 413(a) by adding to the relevant rules the language from Section 413(a) which states, "excluding the value of the primary residence of such natural person" after the requirement that the investor's net worth "exceeds $1,000,000" currently in the rule. Further, in addition to the Dodd-Frank statutory language, this proposed amendment would add the phrase "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 purpose of including this additional language is to clarify the calculation of total net worth by excluding the value of equity in a primary residence.[2]

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[1] Sec, and Exch. Comm'n, Regulation D Offerings, 2009, http://www.sec.gov/answers/regd.htm

[2] Net Worth Standard for Accredited Investors, 76 Fed. Reg. 5307 (proposed Jan 25, 2011) (to be codified at 17 C.F.R. pt. 230).

IV. Discussion of Specific Requests for Comment

1. *Should the value of the residence be calculated by netting out the debt secured by the residence, as proposed? Or would it be more appropriate to exclude the entire fair market value of the residence from net worth, without netting out any associated debt?*

Yes, the value of a primary residence to be excluded from the calculation of net worth should be calculated as the difference between the value of the residence and debt secured by that residence, up to the total value of that residence. The "netting out" approach reflects a strategic interpretation of the proposed amendment to minimize the reduction in the pool of accredited investors to ease the burden imposed on small business as result of the new accredited investor standard.

This approach is appropriate consider the effect of using a residence as the collateral securing a loan. If the loan is defaulted on, the residence may be levied against as a means for the creditor to be made whole. As securing the loan with collateral reduces the creditor's risk, the liability of the debt should be deducted from the individual's net worth up to the value of the property. To count debt secured by a primary residence as a liability while excluding the value of the residence itself would be an inaccurate calculation of net worth under the accredited investor standard.

2. *Would it be more appropriate to substitute the word "equity" for the word "value" when referring to the primary residence in our accredited investor net worth standards?*

To promulgate the clearest and most coherent rule, the term "equity" may more appropriately reflect the common understanding of the net worth calculation. "Equity" is commonly understood as the difference between the value of assets and liabilities. "Value" may be more interpreted as the fair market value of the residence, without deducting debt secure against the residence. However, the additional language of the proposed rule, "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" does much to clarify this calculation. The methodology for calculating the value of primary residence to be excluded is largely more important that the terminology. In light of the additional proposed language, any ambiguity as to what value is to be excluded is likely resolved. The word "equity" is better suited to encourage a consistent understanding of the approach to net worth calculation adopted by the Commission.

3. *Should we interpret Section 413(a) to exclude from the net worth calculation both the fair market value of the primary residence and all indebtedness secured by the primary residence, regardless of whether such indebtedness exceeds the fair market value of the property?*

No, the indebtedness that may be netted out against the value of a primary residence should not be permitted to exceed the fair market value of the property. One of the statutory objectives on Section 413(a) of the Dodd-Frank Act is to weed out investors who may not be able to bear the losses associated with riskier investment offerings. Individuals who have over-secured debt exceeding the fair market value of the primary residence should be required to have additional assets available to pay obligations owed to secured creditors.

This approach may force investors and/or issuers to incur additional costs to perform appraisal valuation on properties in question; however, such burdens should not be overstated as cost prohibitive. This proposed rule does not go so far as to mandate which party should incur such costs. It is possible that the proposed costs of a finite number of valuations can be spread across the entire pool of investment purchasers in the form of incrementally higher purchase prices. The result of this cost spreading may result in a de minimis effect for valuation costs, and other such private solutions may be created to cope with these additional costs.

4. *Is another interpretation of Section 413(a) superior to those we discussed?*

No, I do not believe promulgating such an additional threshold is consistent with the Commission's approach to determining accreditation status. The North American Securities Administrators Association, Inc. ("NASAA") has proposed an alternative threshold standard that may also be incorporated into the definition of accredited investor.[3] The "investment owned" standard set forth by the NASAA recommends that an investor with at least $1,000,000 in investments should qualify as an accredited investor. According to the NASAA, this threshold should be satisfied *in addition to* the current financial thresholds for natural persons.

Although the standard would provide greater protection to potentially vulnerable investors, the burden imposed to achieve accredited status may frustrate smaller businesses in capital-raising efforts. The standard would, in essence, effectively eliminate the existing $1,000,000 net worth standard because investors would be threshold could not be meet without also meeting the more stringent "investments own" million-dollar threshold. The potential shortcoming of this proposal is that it compels investors to maintain their value in investment, rather than a more liquid form, such as a savings account. Further, the definition of an "investment" could stir confusion in complying with the rule. For example, whether the investment must be expressly listed in the rule or must satisfy the *Howey* test standard for "investment contract."[4]

As the Commission is mandated to review these standards periodically, it may weigh the option of creating a third alternative to satisfy accredited investor thresholds. The Commission may propose a "investment owned" threshold, lower than total net worth, that may be satisfied to achieve accredited status (perhaps $500,000). This proposal differs from the NASAA proposal in that the threshold may be satisfied as an alternative to the existing thresholds, rather than in addition to them. The Commission may deem an investor with a certain amount of assets already invested in the market to be diversified enough to bear the risk of more volatile private placements. This alternative may ease the burden of capital formation, without exposing investors to undue risk, because their diversification enables them to bear the potential loss. To ensure diversification, the Commission may also need to require a certain minimum number of different investments.

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[3] *Advance Comment Letter from NASAA* (Nov. 4, 2010) (available at http://www.sec.gov/comments/df-title-iv/accredited-investor/accredited-investor-11.pdf).

[4] *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 301 (1946). The *Howey* test looks to "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.*, 328 U.S. 293 at 301

This option may also include greater complexities that the Commission seeks to avoid, and therefore keeping the existing standards may be preferable. If the Commission, however, seeks to increase the potential pool of accredited investors, after its review of the existing standards, it may weigh this alternative as a means to do so.

5. *Should we define the term "primary residence" for purposes of our accredited investor net worth rules? If we define the term, should we use a definition under the federal income tax code? If so, should we also incorporate into our definition a reference to guidelines issued under the federal income tax code? Alternatively, should we define "primary residence" as the commonly understood meaning of the term—the home where a person lives most of the time? What alternative definitions would you recommend? For example, should we define the term by listing several factors to consider? Would the factors from the IRS publication listed in note 35 be the appropriate factors, or are there different factors that should be included?*

No, the rule should not include a static, statutory definition for the term "primary residence." In most instances, this determination should be self-evident for an investor making a good faith assertion for accreditation. Incorporating a static definition of this term may result in over-burdensome issues or undue complication in complying with its meaning. Investors should be free to make good faith determinations in questionable cases and may look to other sources for instruction.

The availability of other sources, such as the tax code, should not be equated to a requirement to consult such sources. Mandating such a requirement would impose additional costs and time lost which should be necessarily avoided to facilitate capital formation. Potential sources for a definition, such as the tax code, may themselves be unduly complicated and difficult to understand. Further, additional considerations, such as the involvement of foreign investors may result in disparate treatment under the theoretical definition, as the consulted source may not be applicable to them. Likewise, an unfavorable application of the definition for foreign investors may discourage their investment in U.S. markets, hampering American global competitiveness.

Based on these considerations, the Commission should not implement a static definition for "primary residence." A possible alternative to ease the concern of manipulation may be to hold investors who make misrepresentations under the rule liable under the fraud provisions of the Securities Act of 1933 and Exchange Act of 1934. Traditionally, issuers are held liable to selling unregistered securities to unaccredited investors, but extending liability to investors claiming accreditation could serve as an adequate deterrent to prevent misrepresentations.

6. *Should we require inclusion of debt secured by a primary residence in our proposed accredited investor net worth standard if proceeds of the debt are used to invest in securities? How would these proceeds be traced? Would companies and their prospective investors find this standard workable? Should distinctions be made among different kinds of securities? Are there other assets besides securities that should be taken into account?*

It would be impractical for the Commission to require the exclusion of debt proceeds invested in securities from the net worth calculation. The use of loan proceeds borrowed solely for the purpose inflating of net worth to achieve investor status seemingly undermines the letter of the law and policy promulgated under the new net worth standards. Conversely, monitoring such activity raises complications, such as traceability, enforcement, and interfering with an

individual's right to make investment decisions.

The NASAA voiced the concern that an unscrupulous securities salesperson might persuade an individual to take out a home loan in order to manipulate their status as an accredited investor. Individuals who possess large amounts of equity in their homes may net out the balance of the loan against the value of their residence and invest the loan's proceeds in otherwise unsuitable placements.[5]

This conduct would indeed be a circumvention of the policy of protecting inept investors from riskier investments promoted under this rule. This concern is echoed in the Financial Crisis Inquiry Report[6], which noted "homeowners pulled cash out of their homes to send their kids to college, pay medical bills, install designer kitchens with granite counters, take vacations, or launch new businesses."[7] Rampant "over-borrowing" has been attributed as a fundamental cause of the worldwide financial meltdown. Further, the threat of unscrupulous salespersons poses the potential for affinity predation on the elderly, who often possess larger portions of equity in their primary residences. However, protection from affinity predation may be effected through the regulation of issuers and broker-dealers. Reducing an investor's ability to incur debt in order to invest in risky placements may serve as a strong safeguard to protect against systemic risk to the global financial system.

Investor protection forms the core basis of the new accredited investor. However, monitoring an individual's decision to incur debt and invest the proceeds may over-burden the Commission's regulatory abilities. As the Commission is aware, Reg D was enacted to streamline the process of bringing limited and private placement offerings to fruition. Promulgating rules that force the Commission and/or issuers to conduct extensive due diligence to screen potential investors may be costly and hinder the countervailing policy of facilitating capital formation.

Further, as the Commission noted in its Notice of Proposed Rulemaking, the potential or inappropriate or predatory lending practices by "unscrupulous salespersons" may already be addressed under rules governing agents such as broker-dealers. The Commission must be careful to not over-extend its limited resources by creating the additional responsibility of tracing investor loan proceeds. The cost of monitoring so many individual's personal finances would be too difficult and time-consuming for the Commission to undertake.

Lastly, the Commission must also consider the individual's right to make an investment decisions for him or herself. In the American free market economy, individuals must be afforded some degree of autonomy to determine how best to allocate their assets. Investors have some right to undertake riskier opportunities if they are able to satisfy the objective standards for net

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[5] *See Advance Comment Letter from NASAA*, *supra* note 3.

[6] Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011).

[7] *Id.* at 7. Survey evidence show that about 5% of homeowners pulled cash to buy a vehicle and over 40% spent cash on a catch-all category including tax payments, clothing, gifts, and living expenses. Id.

worth. The Commission should grant some deference to this individual right. Therefore, similar regulation of individual investors may be over-broad.

7. *Should the rule provide that the calculation of net worth must be made as of a specified date before the sale of securities under Regulation D, for example, 30, 60 or 90 days, as well as at the time of sale? If not, would investors be likely to inflate their net worth by borrowing against their homes to attain accredited investor status? If we required that the net worth calculation be made a significant period of time in advance of the sale, would such a requirement make the calculation unduly complex or otherwise make exempt offerings to accredited investors less useful for issuers?*

No, the rule should not provide a timing framework as to when the net worth calculation must be made. This framework would result in the double calculation of net worth, as the calculation must be made at some specified date and again at the time of sale to ensure accreditation status. Such an obligation would be over-burdensome and costly to investors and issuers alike. Further, imposing such a time framework would do little to prevent investors from borrowing and investing proceeds to inflate their net worth. Investors would simply just need to be more scrutinizing about when to assume the borrowing.

This framework would greatly hinder the manner in which limited securities investments are offered. One of the benefits of exemption from registration is to avoid time constraints involved with filing delays for effectiveness of offerings. Imposing a time framework for when net worth must be calculated may force issuers to keep their placements open for longer windows than they originally intended, and hinder their capital raising efforts. For example, a small business seeking an immediate capital infusion from a few accredited investors may be forced to wait weeks or months while investors calculate their net worth in compliance with the timeframe.

Additionally, these calculations may be ineffective as they are subject to shifts in the market. Issuers may be compelled to make initial calculations or close tentative sales on days where the overall market is "up," as the value of purchasers or other investments may be artificially high. These complications would produce undue complications for investors and issues and create regulatory enforcement difficulties for the Commission.

If such a rule is promulgated, it could greatly slow down the process of capital formation. The Commission must consider how frequently the information investors use to calculate their net worth is made available. As many investments issue quarterly reports on their current value, investors could be forced to make their net worth calculation far in advance of investing in the private placement, or be obliged to wait for a new investment report to make meaningful updates to the value of their assets. Such a prolonged timeframe would have a strong negative impact on companies seeking fast capital infusions.

As I suggested in my discussion of the defining "primary residence," an alternative approach may be to who investors who misrepresent the value of their total net worth liable under the fraud provision of securities laws. Extending liability to investors who knowingly misrepresent themselves as possessing the net worth threshold for accreditation may serve as an adequate deterrent to prevent such fraud. Likewise, continuing to hold issuers liable for selling to unaccredited investor serves as another level to verify investors' assertions.

8. *Issuers and investors have calculated net worth under the Regulation D accredited investor standards for many years without specific instructions in the rules on how the calculation should be performed. Would guidance in the rules on how to calculate net worth, in addition to the new standards governing valuing the primary residence and treating related mortgage debt, be helpful? For example, should we adopt rules specifying what should be included as assets and debt, and how various kinds of assets should be valued? If so, what additional rules would be appropriate?*

No, this guidance need not reach the prescribed level of a step-by-step procedure to assist investors. However, some insight or instructive examples may be informative for investors who seek assistance in calculating their net worth.

Traditionally in private and limited placement offerings, investors have been responsible for making self-determinations as to whether the value of their net worth exceeds the statutory thresholds. Although providing more detailed guidance on these standards may be instructive, this guidance inherently creates higher costs for compliance with the letter of the law. Creating thorough rules or steps for compliance threatens to over-complicated the accredited investor standard, similar to the opaqueness of the U.S. Tax Code.

Again, holding investors liable for knowingly misrepresenting the value of their net worth could serve as a strong deterrent for prevention. Further, holding issuers equally responsible for selling securities to unaccredited investors advances the policy of screening of the pool of investors within the private sector. Issuing a mandated procedure to guide investors in calculating net worth would impose unnecessary costs on issuers seeking to replicate the process in order to verify the accuracy of investors' calculations.

9. *Should we adopt any transition or other rules providing that an investor who previously qualified as an accredited investor before enactment of Section 413(a), or adoption of the proposed amendments, may continue to qualify as such for purposes of subsequent or "follow-on" investments, such as investments to protect its proportionate interest in a company or fund or to exercise rights that arise because of that interest, or would that be inconsistent with the purposes of Section 413(a)? If we should adopt such an approach, are there other types of investments that should qualify for such treatment? Would investors' ability to protect their then-existing investments be inappropriately adversely affected if we did not provide such treatment? Would issuers' ability to raise capital be inappropriately impeded if we did not provide such treatment? If we did this, should we limit the amount of permissible follow-on investments, such as limiting them to the amount necessary to protect the investor from dilution? What conditions should we place on qualifying for such treatment? Is this unnecessary because the Section 4(2) private placement exemption may be available for sales to such an existing investor? Instead, should we provide that an investor who previously qualified as an accredited investor, but no longer qualifies as a result of Section 413(a), would not count towards the 35 non- accredited investor limitation of Rules 505(b) and 506(b) for offerings by issuers in which the investor held investments at the time the Dodd-Frank Act was enacted?*

Yes, special transition exemptions should be permitted for investors involved in existing limited placement offerings who no longer qualify as accredited investors under Section 413(a) of the Dodd-Frank Act. Existing investors who no longer qualify as accredited should be afforded a "grandfather" exemption to remain in their investments. Additionally, this exemption

should enable these investors to make additional capital investments in future limited placement offerings by their issuer, without potential for blowing the offering's exemption under Rule 505 or Rule 506 for exceeding the limit of 35 non-accredited investors. In comments related to this proposed rulemaking, Commissioner Kathleen L. Casey stated, "I do not believe it would consistent with Congressional intent to harm existing investors by effectively stripping them of these contractual rights by making further investments. Accordingly, I strongly encourage affected investors and companies to comment on this issue."[8]

Investors' special exemptions related to extending their accredited eligibility should be limited to relationships with existing issuers. It would be inapposite to inform investors they are no longer able to continue their investment in a company as a result this newly proposed rule. Likewise, investors should be entitled to continue to make capital contributions in their existing investments in order to earn profits, as the contributions they have previously made may be immeasurably linked to the success of the business to date.

Investors, however, should not be able to extend their exemption to other new private or limited placement offerings requiring accredited status with new issuers. Accordingly, issuers seeking to offer a new exempted offering should be required to conform to the new accredited investor standards for all new investors in the offering. Further, investors who purchase securities from another investor, who possesses a grandfather exemption for accreditation, should be required to conform to the new rules for net worth calculations.

This approach to transitioning investors who have lost their status seems to be the most equitable solution and most consistent with the objectives set forth in the proposed rulemaking.

V. Conclusion

Investor protection is a compelling policy goal of the Commission as this country emerges out of the financial recession of the previous years. In as much as this new standard for accredited investors protects everyday investors, I write in favor of Proposed Rule S7-04-11. Although this change is already in effect in American markets, I believe the comments sought by the Commission will provide greater transparency to the accredited investor status, and provide thoughtful feedback as the Commission continues to review these definitions. I commend the Commission for promulgating a rule that grants greater protection to securities investors, without creating undue burdens on companies seeking to raise capital.

I would like to thank the Commission for this opportunity to comment, and respectfully request that the Commission consider the suggestions I have made throughout this comment. I believe they may prove useful in aiding the Commission to resolve the ambiguities related to this proposed rulemaking, and in continuing its review of the accredited investor standard.

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[8] Kathleen L. Casey, Commissioner, Sec. and Exch. Comm'n, Statement at SEC Open Meeting Regarding Adopting Releases on Net Worth Standard for Accredited Investors and Shareholder Approval of Executive Compensation and Golden Parachute Compensation (Jan. 25, 2011).