More On The New Accredited Investor Regulations

By

Joe Wallin
– January 28, 2011

You might be wondering how the SEC's proposed regulations affect, if at all, prior SEC guidance on how to take into account debt on a primary residence in excess of the value of the residence for purposes of determining whether an investor meets the $1M net worth standard. And you might recall that following the passage of Dodd-Frank the SEC posted the ***following guidance*** on its web site:

Question: Under Section 413(a) of the Dodd-Frank Act, the net worth standard for an accredited investor, as set forth in Securities Act Rules 215 and 501(a)(5), is adjusted to delete from the calculation of net worth the "value of the primary residence" of the investor. How should the "value of the primary residence" be determined for purposes of calculating an investor's net worth?

Answer: Section 413(a) of the Dodd-Frank Act does not define the term "value," nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person's primary residence must be excluded. Pending implementation of the changes to the Commission's rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. **Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth**. [July 23, 2010]

The SEC's proposed regulations do not change the SEC's position stated in the last sentence in bold above.

Although the new regulations could be clearer on this point, they do say the following:

- “The conventional or commonly understood meaning of the term [net worth] is the difference between the value of a person’s assets and the value of the person’s liabilities.”
- They do not expressly contravene the guidance previously posted on the SEC’s web site.
- The guidance previously posted on the SEC’s web site stating that mortgage debt over value reduces net worth remains on the site.
- Under the commonly understood definition of net worth, which the SEC says is the test, mortgage debt in excess of value on a primary residence would reduce net worth.

Accordingly, companies should still be instructing potential investors that in order to qualify as accredited investors by virtue of meeting the $1M net worth test, any mortgage debt in excess of the value of a primary residence must reduce overall net worth for purposes of the calculation.

The new net worth definition for individuals, as set forth in the proposed SEC regulations is as follows:

Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of purchase, exceeds $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;