Cornell University
Law School

Lawyers in the Best Sense

WILLIAM A. JACOBSON
Associate Clinical Professor of Law

G57 Myron Taylor Hall
Ithaca, New York 14853-4901
T: 607.255.0203
F: 607.255.1260
E: waj24@cornell.edu

March 11, 2011

(Via Electronic Filing)

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Rule on the Net Worth Standard for Accredited Investors
<u>File Number S7-04-11 (the "Rule Proposal")</u>

Dear Ms. Murphy:

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to comment on the Commission's proposed rule (the "Proposed Rule") amending the net worth standard for accredited investors, as required by Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and contained in Rules 215 and 501 under the Securities Act of 1933 (the "1933 Act"), as set forth in SEC File Number S7-04-11 (the "Rule Proposal"). The Clinic is a Cornell Law School curricular offering, in which law students provide representation and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu

Section 413(a) of Dodd-Frank requires the net worth calculation for "accredited investors," those able to purchase certain unregistered securities, to "exclud[e] the value of the individual's primary residence." Section 413(a) does not define "primary residence," nor does it provide a method for calculating the "value" of a primary residence, so the Commission must determine whether or how to address each of these matters in the Proposed Rule.

The Clinic believes that the Commission's Proposed Rule will help protect investors; however, significant loopholes still allow the leveraging of investor homes to wrongly qualify those investors as "accredited." As set forth below, the Clinic suggests a number of changes. First, the Rule should define "primary residence" by reference to "principal residence" within Section 121 of the Internal Revenue Code. Second, existing Rule 506 provides sufficient protection to now-unaccredited investors to eliminate the need for another transitional Rule. Third, the Proposed Rule should require an estimation of an investor's net worth as it was on the date 60 days prior to the purchase of the securities, as well as at the time of purchase. Finally, the Rule should plainly state that residentially-secured debt in excess of the home's fair market value is a liability against other assets.

1. The Clinic's Proposed Changes to the Proposed Rule

The Clinic suggests specific changes to the Proposed Rule to close significant loopholes and clarify the Proposed Rule. The language of the Proposed Rule defining an "accredited investor" is reproduced below (from Rule Proposal, p. 7). The Clinic's proposed additions are underlined, and deletions are lined through:

> Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of purchase <u>and on the date 60 days before the time of purchase,</u> exceeds $1,000,000 excluding the value in 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. <u>Such debt in excess of the estimated fair market value of the property shall be a liability against other assets. The term "primary residence" as used here is the same as "principal residence" within the meaning of Section 121 of the Internal Revenue Code.</u>

2. "Primary Residence" in the Proposed Rule Should be Defined by Reference to "Principal Residence" in Section 121 of the Internal Revenue Code

The Commission requested comment on whether or how it should define the term "primary residence" in the Rule (Rule Proposal, pp. 11–12). The Rule should define "primary residence" by reference to Internal Revenue Code § 121. The Commission proposes to leave "primary residence" undefined in its Proposed Rule, because it is undefined in other existing Rules (see Rule Proposal, pp.11–12). However, the term's use in those Rules does not relate to protecting the investor's home from potentially dangerous investments. The Clinic believes that this loophole could render the change required by Dodd-Frank Section 413(a) meaningless when applied to many investors with multiple homes. Leaving the term undefined allows leveraging of the home in which the investor lives most of the year in order to qualify to purchase unregistered securities, by calling "primary" what would otherwise be a secondary home. This might be done, e.g., where the fair market value of the (otherwise) secondary home is less than the investor's equity in the home in which the investor lives most of the time.

For instance, take the example of a retired investor who has $500,000 in cash and a small condominium in New York City with a fair market value of $300,000, against which the investor has $200,000 in mortgage debt. The investor spends two months each year in the New York condominium, and rents it out for the other ten months. The investor's only broker, accountant, and bank accounts are in New York. The investor lives for ten months each year in her house in Miami, with fair market value of $1.4 million, against which she has $600,000 in mortgage debt. Since the investor earns income in New York, she files New York and Florida income tax forms.

Because "primary residence" is undefined in the Proposed Rule, one could argue that New York is the investor's "primary residence" for financial and investment purposes, since all of her significant financial activity occurs there. Thus, the $800,000 in equity from the Miami home would be added to the $500,000 cash in calculating net worth, for a result of $1.3 million. This would also allow the investor to incur significant debt against the equity in the Miami home in order to purchase private placement securities, without becoming "unaccredited." While such an outcome is against the spirit of Dodd-Frank, the Commission's Proposed Rule could allow it.

Under the Clinic's changes to the Proposed Rule, the investor in the example above would have net worth of $600,000, because the rule treats the Miami home as primary and includes only the $100,000 equity from the New York property in the net worth calculation. The Miami home is "primary" by reference to IRC § 121, despite that her financial events occur in New York. Using this definition better affects apparent Congressional intent, because the investor cannot leverage equity in the home in which she lives most of the year in order to buy unregistered securities.

3. Existing Rules Sufficiently Allow Sophisticated <u>Investors to Maintain Proportional Interests</u>

Some investors who were accredited prior to Dodd-Frank's enactment are no longer accredited because of Section 413(a). This means that some investors will lose the ability to maintain proportional interests in some securities, because the investors will no longer qualify to continue purchasing those securities. Accordingly, the Commission requested comment on whether it should create a transition rule, whereby those now-unaccredited investors could purchase private placement securities in order to maintain their proportional interests in that security; but not purchase other private placement securities (see Rule Proposal, p. 14).

The Clinic does not support creation of such a transition rule. The Clinic believes that the present amendment is itself a transition rule, providing for an easier transition to the 2014 amendment, when the Commission finally can, and should, increase the minimum net worth required for investor accreditation above $1 million. Congressional intent in this regard is evident from the fact that Section 413(a) of Dodd-Frank provides no other transition rules and was effective immediately upon enactment. This shows Congress' belief that many investors were inappropriately able to purchase private placement securities under the old Rule.

Where an investor is "sophisticated" enough to purchase securities through private placements, even though she is no longer an accredited investor, she will be able to maintain her proportionate interest in many cases. "Sophisticated investors" are those who, under Rule 506(b)(2)(ii) of the 1933 Act, "either alone or with their purchaser representative have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment." Where an investor is neither sophisticated, nor accredited, she should not be able to continue purchasing any private placement securities, as this is precisely the investor that Congress means to exclude immediately from the private placement market.

4. The Proposed Rule Should Also Require Estimation of the Investor's Net Worth as it was 60 Days Before the Intended Date of Purchase

The Commission requested comment on how or whether, within the Proposed Rule, to deter investors from taking home equity loans in order to inflate apparent assets, and thereby wrongly qualify as accredited investors (Rule Proposal, p. 13–14). The Commission proposed not to put any such deterrent measures within the Proposed Rule. Under the Commission's Proposed Rule, an individual with significant home equity could incur large home equity debts to purchase assets, merely to qualify as an accredited investor, without this debt appearing as a liability against non-residential assets. The Clinic's proposed change would impose a timing requirement for the net worth calculation, in order to prevent such inflation of assets merely to qualify an investor as accredited.

The Clinic's proposed timing rule would require an estimation of an investor's net worth as it was on the date 60 days prior to the purchase of the securities, as well as at the time of purchase. Under such a requirement, if the investor would not have qualified as "accredited" 60 days before the intended date of purchase, then the investor could not be considered "accredited" on the intended date of purchase.

This timing requirement will help prevent investors from incurring home equity debt in order to inflate their net worth simply to qualify as accredited. The Commission suggests that a timing rule would require that the investor know of the offering well enough in advance to perform the calculation 60 days before purchase, which could be unreasonable in private placement markets. The Clinic believes that a timing rule should not require the "60 day" calculation to be performed on the date 60 days before the purchase date; rather, the calculation should occur on the intended purchase date, and estimate the investor's net worth as it was on the date 60 days before the intended purchase date.

5. The Rule Should Plainly State that Mortgage Debt in Excess of the Home's Fair Market Value is a Liability Against Other Assets

The Proposed Rule should also plainly state that residentially-secured debt in excess of the property's fair market value is a liability against the individual's other assets. This will prevent the misinterpretation that investors with "underwater" mortgages may simply ignore the excess debt when performing the net worth calculation. Presumably, the Rule should help to prevent such an investor from purchasing high-risk securities.

Conclusion

The Clinic greatly appreciates the opportunity to comment on the Proposed Rule. While supporting the Commission's interpretation of Dodd-Frank Section 413(a) in spirit, the Clinic believes that significant loopholes in the Proposed Rule will allow leveraging of some investor's homes to qualify those investors wrongly as "accredited." Accordingly, the Clinic urges the Commission to consider the Clinic's proposed changes to the Proposed Rule, which close those loopholes and ensure the level of investor protection envisioned by Section 413(a).

Respectfully Submitted,

William A. Jacobson, Esq.
Associate Clinical Professor of Law
Director, Cornell Securities Law Clinic

Alexander B. Sutherland
Cornell Law School, Class of 2012