REGULATORY REPORT CARD | March 2014

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AGENCY

US Securities and Exchange Commission (SEC)

Rule title
Net Worth Standard for Accredited Investors

RIN	3235-AK90
Publication Date	December 29, 2011
Stage	Final

RULE SUMMARY

The regulation alters calculations that determine whether an individual is an "accredited investor" qualified to invest in certain securities exempt from Securities Act registration. Accredited investors are high net worth investors, considered to be sophisticated, and so can purchase certain securities not available to the general public. This rule makes the definition of an accredited investor more stringent by preventing people from claiming the value of their primary residence as an asset contributing toward their net worth. The changes conform Securities and Exchange Commission (SEC) rules to the Dodd-Frank Act's requirement that the value of a primary residence must be excluded from net worth. Debt against the primary residence is also excluded from net worth unless (1) the debt was incurred within 60 days of the time the investor sought to qualify as an accredited investor, or (2) the debt exceeds the value of the residence (in which case the excess counts against net worth). It includes a limited grandfathering provision that allows investors who qualified under the old definition but not the new one to continue to buy securities they already had the right to buy or make follow-on investments.

COMMENTARY

The regulatory analysis offers no real explanation of the systemic problem the rule solves, instead assuming the rule is necessary because Dodd-Frank mandates it. The analysis does a good job of attempting to foresee changes in human behavior when people try to "game" the rule, and the commission appears to have listened closely to people who commented on the proposed regulation. However, costs and benefits are not quantified in the analysis. The alternatives are extremely narrow. There is no mention of ways of tracking the results moving forward. In fact, it seems the commission doubts that data exist to track the results. Additionally, this rule is strange in that it appears that people can state the value of their home and don't need any verification that this is the true fair market value. While this reduces compliance costs, it may also make fraud easier. Finally, in the absence of further explanation, the 60-day waiting period seems like it will do little to discourage investors from taking on more debt in order to meet the SEC's definition of an accredited investor.

This rule's economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce's study, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There.'"
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OPENNESS	SCORE	COMMENTS
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1A
2. How verifiable are the data used in the analysis?	1	1B
3. How verifiable are the models and assumptions used in the analysis?	0	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	8	

ANALYSIS	SCORE	COMMENTS
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	2	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	4	

USE	SCORE	COMMENTS
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	2	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	3C
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	0	3D
Total Use (Sum of 9–12)	2	

Total Score	14	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria.
This analysis was scored on a scale from zero to 60 points.

OPENNESS			
Criterion	**Score**	Com. No.	Comment
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1	A keyword search and a RIN search both turn up the rule readily on regulations.gov. A link to the final rule is four clicks from the SEC home page, via headings labeled "regulations." The economic analysis is contained in sections IV, V, and VI of the Federal Register notice devoted to, respectively, cost-benefit analysis; effects on competition, efficiency, and capital formation; and Regulatory Flexibility Act analysis.
2. How verifiable are the data used in the analysis?	1	2	The only data really mentioned in the analysis is the 2007 and 2009 Federal Reserve Board Survey of Consumer Finances. A link is provided and this data is readily available online, although the analysis mentions that the 2009 data is not yet public but that the SEC has learned it is largely consistent with the 2007 data. The agency does a good job of identifying this source; however, it is really the only source mentioned, and it is used to show that the new definition of accredited investors will not affect more than a few hundred thousand people. While this is useful, there are really no data shown to support the benefits or costs of the rule beyond this point.
3. How verifiable are the models and assumptions used in the analysis?	0	3	There are no explicit models, assumptions, theories, or research cited in the very brief analysis.
4. Was the analysis comprehensible to an informed layperson?	2	4	The analysis was mostly easy to read but very cursory. A few parts had to be read multiple times to understand the differences between regulatory alternatives. Benefits, costs, etc., are just asserted, so it's not really clear whether there is much analysis justifying the assertions.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	3	5A	The analysis names four benefits: lower transaction costs for investors relative to other alternative ways of calculating net worth; cost savings for issuers relative to alternatives because the pool of investors is larger; protection of investors from high-pressure sales tactics (and, implicitly, from their own bad judgment); and protection of the rights of investors who qualified under the old but not the new definition through limited grandfathering. The first two and last one appear to be benefits to the affected parties, but the first two are relative to other alternatives, not relative to the current situation or a baseline. The SEC concludes that these regulations may improve efficiency and capital formation relative to the alternatives considered. The analysis also asserts that clear rules (as opposed to not issuing rules) will reduce uncertainty, increase confidence in capital markets, reduce the cost of capital, and enhance capital availability to small businesses.
Does the analysis identify how these outcomes are to be measured?	0	5B	The value of these benefits is not quantified. Only one calculation is presented, which shows that the number of investors is unchanged regardless of how the rule treats underwater debt. This measures the number of people affected but not the outcome for them or for society.

Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	1	5C	The analysis asserts somewhat plausible reasons the first four benefits may occur, but it offers no behavioral theory that lays out the causation mechanism in a logical fashion. One could surmise that the reason is because many investors during the housing bubble were underwater in their mortgages but were still considered accredited investors and so were allowed to make risky investments. This is not mentioned in the analysis, however.
Does the analysis present credible empirical support for the theory?	0	5D	No empirical support is presented other than the calculation that shows the underwater debt decision does not affect the number of investors. In fact, the analysis claims there is no way to measure the effects.
Does the analysis adequately assess uncertainty about the outcomes?	2	5E	There is brief mention of uncertainty surrounding fair market value of a residence. But there is no mention of uncertainty surrounding the outcome of the rule. There is also some mention that some investors may try to game the system, but the agency thinks this will be resolved by the 60-day waiting period.
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0		
Does the analysis identify a market failure or other systemic problem?	0	6A	There is no explicit discussion. The Regulatory Flexibility Act analysis merely states that the purpose of the regulations is to implement requirements of the Dodd-Frank Act. This is particularly striking because the apparent problem could have been stated easily: some people appeared to have much higher net worth than they really did due to having highly leveraged homes. The analysis does not mention this, though.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	0	6B	In several places, the SEC asserts that excluding some marginal investors from eligibility confers benefits on them by protecting them. This implies some kind of theory that these investors do not know how to make decisions in their own best interest, but no such theory is explicitly offered.
Does the analysis present credible empirical support for the theory?	0	6C	No evidence is presented in support of the nonexistent theory of a problem.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	Since the problem is not even defined, there is no relevant discussion of uncertainty.
7. How well does the analysis assess the effectiveness of alternative approaches?	2		
Does the analysis enumerate other alternatives to address the problem?	3	7A	The analysis presents alternative ways of implementing certain parts of the rule. In particular, it mentions changing the ways of measuring the amount of equity in a home or changing the waiting period that is allowed for investors to increase the amount of debt financing their mortgage. The Regulatory Flexibility analysis mentions several possible alternatives for treating small issuers differently. These are small details, though, and not really alternatives to the larger rule, which now excludes the value of a person's home as part of a person's net worth.

Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	1	7B	Alternatives are narrow tweaks that consider different ways of treating debt, not alternative solutions to the problem the regulation is supposed to solve. The SEC explicity declined to consider or analyze any alternatives outside the narrow discretion granted in the Dodd-Frank Act.
Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	1	7C	Outcomes are not measured, and outcomes of alternatives are not measured. The only exception is a calculation that assesses whether treating debt differently would alter the number of eligible investors. Other results are discussed in very cursory fashion. The Regulatory Flexibility section asserts that no small business alternatives are feasible or they would have no impact.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	1	7D	The analysis builds the Dodd-Frank requirement for excluding the primary residence from net worth into the baseline. It compares the several alternative tweaks to each other. It asserts that issuing the regulations provides greater clarity than not issuing the regulations. For the other benefits, there is no comparison with the "no new regulation" alternative.
8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	2	8A	The analysis qualitatively lists several incremental costs of the alternatives chosen: more complex net worth calculations, greater incentive to take on debt to inflate one's net worth, a smaller pool of eligible investors compared to the alternatives, and reduced "investor protection" for investors who take advantage of the grandfathering provisions. None of these costs are calculated or monetized.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	1	8B	A few factors that might lead to some increased expenditures are alluded to but not really analyzed and definitely not estimated.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	1	8C	The analysis mentions that issuers of securities may have a smaller pool of investors to sell to. This could impact the price of securities.
Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	2	8D	A few brief discussions of how individuals might "game" the regulations and measures taken to counter this, but no significant discussion of costs created by behavioral changes. The analysis says that some people may be encouraged to take on more debt in order to meet the standard of an accredited investor. In response to this, the agency has created a 60-day waiting period after taking on more debt. "We believe that the amendments impose no significant burden on efficiency, competition, and capital formation beyond any that may have been imposed by the enactment of the Dodd-Frank Act."
If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	1	8E	The analysis acknowledges briefly that if the SEC is wrong and these regulations reduce the pool of qualified investors, this might be a cost. Otherwise, the analysis mentions uncertainty surrounding fair market value of people's homes, and it also mentions that the rule is being issued to reduce uncertainty. There is no mention of uncertainty surrounding costs, however.

Does the analysis identify the alternative that maximizes net benefits?	0	8F	There is no calculation or qualitative discussion of net benefits.
Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	There is no calculation or qualitative discussion of cost-effectiveness.
Does the analysis identify all parties who would bear costs and assess the incidence of costs?	2	8H	The analysis mentions that some individuals will no longer be accredited investors and that this will have costs both to these individuals as investors as well as to issuers of securities who could have sold to them. The incidence of costs is not measured.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	1	8I	Benefits would go to protecting households from "high-pressure sales tactics." Thus, only sophisticated investors would be able to invest in riskier Regulation D securities. There would also be benefits to investors as a whole since the rule should reduce uncertainty, promote efficiency, and facilitate capital formation. These are all pretty vague ways of describing who benefits from the rule, however. Since benefits are not calculated, there is no apportionment among affected parties.
USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	2	9	The notice justifies excluding underwater debt on the grounds that this decision does not affect the number of eligible households. In this sense, the SEC used the calculation—though one could just as easily argue for the opposite decision since the number of people affected is unchanged. Most of the justifications for the regulations turned on the SEC's interpretation of the Dodd-Frank Act's language and the merits of arguments raised in comment letters.
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	10	Net benefits were neither calculated nor discussed qualitatively, so there is no evidence that the SEC even considered net benefits.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	11	The SEC proposes no goals or measures, makes no commitment to retrospective analysis, and does not provide an economic analysis that could readily be used to develop goals and measures.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	0	12	The SEC mentions no data that could be used to evaluate the regulation's benefits or costs in the future, and the economic analysis provides no indication of data the SEC could use.