

SUPPLEMENTAL MEMORANDUM

March 1, 1982

TO: The Commission

FROM: The Division of Corporation Finance (the "Division")

SUBJECT : Regulation D

RESPONSIBLE STAFF PERSONS : Paul A. Belvin (x22644); David B.H. Martin (x22573)

The Division recommended in its action memorandum of February 16, 1982, that accredited investor status under Regulation D and Section 4(6) of the Securities Act be extended to "any natural person who had individual income in excess of \$100,000 in each of the two most recent years and who reasonably expects an income in excess of \$100,000 in the current year." Commentators recommended use of the term "income" since the proposed standard utilizing "adjusted gross income" does not include certain deductions or exempt income and would thereby exclude from accredited investor status many sophisticated investors who can reduce their gross income below \$100,000 through legitimate tax planning.

After further consideration, the Division believes that in view of the use of a flexible "income" test, which will permit inclusion of additional items of income from that proposed, and the impact of inflation on such a test, that the \$100,000 income figure may be too low to reflect a level of sophistication and an ability to fend appropriate to accredited investors. These decisions are not subject to empirical certainty and must necessarily represent "judgment calls" by the Commission, however, the Division recommends that the income standard for accredited investor status be adopted at \$200,000. The North American Securities Administrators Association Subcommittee and the Division of Enforcement concur in this recommendation.

Attachment: Revised pages 22 - 25, 52 and 56.

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e. Rule 501(a)(5) - \$1,000,000 Net Worth Test. This category extends accredited investor status to any natural person whose net worth at the time of purchase is \$1,000,000. Net worth may be either the individual worth of the investor or the

joint net worth of the investor and the investor's spouse. [Footnote: Commentators noted that the proposed rule, which limited net worth to that of the individual investor, presented numerous problems for investors in community property states or for investors with assets held in joint name with a spouse. Recognizing these problems, the Commission has modified the net worth test to include joint net worth.] The Commission proposed a level of \$750,000 for this test. Some commentators, however, recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to \$1,000,000 without exclusions.

f. Rule 501(a)(6) - \$200,000 Income Test. A natural person who has an income in excess of \$200,000 in each of the last two years and who reasonably expects an income in excess of \$200,000 in the current year is an accredited investor.

As proposed, this category was based on individual adjusted gross income reported for federal income tax purposes in the most recent tax year. Commentators objected

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to that formulation for three reasons. First, reliance on the federal income tax return presented several problems. Foreign investors may not be required to file or to report all income on a United States tax return. Also, individual adjusted gross income may not be a useful figure for an investor who files a joint tax return or who resides in a community property state. Second, in measuring income only in the most recent tax year, the category included investors who had a nonrecurring peak in income for that year. Thirdly, commentators expressed concern about the general concept of adjusted gross income which does not include certain deductions or exempt income and may thus exclude from accredited investor status many sophisticated investors who can reduce their gross income below \$100,000 through legitimate tax planning measures.

The category as adopted is intended to address these concerns. The test is no longer keyed to the federal income tax return. Further, the requisite income level must have been sustained over the two most recent years and the investor must reasonably expect continuation of an adequate level in the year of the investment. [Footnote: For an investor purchasing securities in March 1982, income in calendar years 1980 and 1981 and reasonably expected income in 1982 would be used in determining accreditation under this category.] Also, the term "adjusted gross income" has been changed to "income". As noted

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above, use of the term "income" will permit the inclusion of certain additional items of income, such as interest on municipal bonds, which would be excluded from the proposed concept of adjusted gross income. Accordingly, the appropriate income level has been raised to \$200,000.

The rule as adopted does not define the term "income". Rather than adopting a definition, the Commission has determined to utilize a flexible approach, thereby avoiding the issues raised by inclusion in the rule of federal tax law concepts. However, the Commission is concerned that the decision not to define "income" may be misconstrued. The determination of what is and is not "income" is important in establishing the type of investor intended to be included in this category of accredited investor. Note that the term "income", and not "revenues", has been selected as the appropriate term. For example, the revenues of a sole proprietorship would not give an accurate picture of the income of a self-employed person without deducting the operating expenses of the person. On the other hand, an employee's salary could be a useful figure in determining whether the employee meets the requisite income level provided the employee has not incurred significant expenses in connection with earning that salary.

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One possible method of computing income is as follows: individual adjusted gross income (assuming that had been reported on a federal tax return) increased by any deduction for long term capital gains under section 1202 of the Internal Revenue Code (the "Code"), any deduction for depletion under section 611 et seq. of the Code, any exclusion for interest under section 103 of the Code, and any losses of a partnership allocated to the individual limited partner as reported on Schedule E of Form 1040 (or any successor report).

g. Rule 501(a)(7) - Entities Made up of Certain Accredited Investors. The proposed definition of accredited investor did not take into account an entity owned entirely by accredited investors. Rule 501(a)(7) of the final regulation extends accredited investor status to entities in which all the equity owners are accredited investors under Rule 501(a)(1), (2), (3), (5) or (6).

2. Affiliate. The definition of affiliate in Rule 501(b) is the same as that contained in Rule 405 of Regulation C (17 CFR 230.405).

3. Aggregate offering price. Rule 501(c) defines the method for calculating the aggregate offering price. With the

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(3) an unconditional obligation to pay cash or securities for which market quotations are readily available which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (4) the cancellation of any indebtedness owed by the issuer to the purchaser;

(d) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(e) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years and who reasonably expects an income in excess of \$200,000 in the current year; and

(f) Any entity in which all of the equity owners are accredited investors under paragraph (a), (b), (d), or (e) of this section 230.215.

7. By adding a new Regulation D, §§ 230.501 through 230.506, to read as follows:

REGULATION D - RULES GOVERNING THE LIMITED OFFER AND SALE OF SECURITIES WITHOUT REGISTRATION UNDER THE SECURITIES ACT OF 1933

Preliminary Notes

1. The following rules relate to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the "Act") [15 U.S.C. 77a et seq., as amended]. Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their

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(iv) the cancellation of any indebtedness owed by the issuer to the purchaser;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(6) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years and who reasonably expects an income in excess of \$200,000 in the current year; and

(7) Any entity in which all of the equity owners are accredited investors under paragraph (a)(1),(2),(3),(5), or (6) of this §230.501.

(b) Affiliate. An "affiliate" of, or person "affiliated" with, a specified person shall mean a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.

(c) Aggregate offering price. "Aggregate offering price" shall mean the sum of all cash, services, property, notes, cancellation of debt, or other consideration received by an issuer for issuance of its securities. Where securities are being offered for both cash and non-cash consideration, the aggregate offering price shall be based on the price at which the securities are offered for cash. If securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within