



NASAA

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October 26, 2007

Ms. Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

By E-Mail to: rule-comments@sec.gov

RE: Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828; IC-27922; File No. S7-18-07

Dear Ms. Morris:

The North American Securities Administrators Association, Inc. (“NASAA”)¹ appreciates the opportunity to comment on the above-referenced release (“Release”). NASAA commends the Commission for various proposals contained in the Release, especially those that increase the financial requirements for an individual to meet the “large accredited investor” standard in the proposed new exemption, that recognize the need for inflationary adjustments in the financial standards for accredited investors, and that adopt disqualification provisions for persons relying on the exemption from registration for securities offerings under Regulation D. Representatives of NASAA and the Commission’s Corporation Finance Division have discussed many of these concepts through the years, particularly at our annual SEC/NASAA Section 19(d) meeting, and we are very pleased to comment on issues brought forth in the Release. As set forth below, some of the proposals in the Release threaten to compromise investor protection and should be revised consistent with the protection of investors.

- 1. The incorporation of inflation adjustments into the accredited investor definition will prevent further erosion and enhance investor protection; however, failure to adjust the current thresholds to account for the impact of inflation over the past twenty-five years causes the current “accredited investor” definition to provide inadequate protection for investors.**

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

NASAA has long advocated for adjusting the definition of “accredited investor” in light of inflation and has expressed concern at the length of time the thresholds contained in the definition have not been adjusted.² NASAA strongly supports the proposal to tie the financial thresholds contained in the definition of “accredited investor” and “large accredited investor” to an inflationary index. As set forth in NASAA’s letter of April 2, 2007,³ inflation has seriously eroded the efficacy of the existing thresholds in the definition of “accredited investor” since their adoption in 1982.

NASAA further supports an inflation adjustment every five years. As noted in NASAA’s April 2, 2007 letter, the inclusion of an inflation adjustment in the rules promises to ensure that the protections sought for investors will not be continually eroded by the effects of inflation.⁴ However, we are concerned that the first inflationary adjustment to the definition of “accredited investor” will not occur for another five years, and that the levels will only be adjusted for inflation during that time. An immediate inflationary adjustment to the definition of “accredited investor” is necessary to protect persons that may not have the financial qualification once presumed by the definition.

As noted in NASAA’s April 2, 2007 letter, the income and net worth levels that apply to natural persons for the purpose of satisfying the definition of “accredited investor” were adopted in 1982 as quantitative standards to identify investors who could presumably “fend for themselves without the protections afforded by registration”⁵ when investing in private offerings.⁶ As we indicated in that letter and five years earlier in our March 4, 2002 letter commenting in response to Release No. 33-8041, while those standards may have made sense twenty-five years ago, they are entirely inadequate today.⁷ The income and net worth standards have not been adjusted for inflation a single time since their adoption.⁸ Waiting another five years for an inflationary adjustment, and using today as the benchmark for the adjustment, rather than 1982 when the standards were enacted, fails to protect investors who may lack the wealth and presumed qualification once considered to be ensured by the definition of “accredited investor.”

² See Letter from Joseph P. Borg, NASAA President and Director, Alabama Securities Commission, to Jonathan G. Katz, Secretary, SEC (Mar. 4, 2002) (regarding the proposed definition of Qualified Purchaser in Securities Act Release No. 33-8041), *available at* <http://www.sec.gov/rules/proposed/s72301/borg1.htm> [hereinafter March 4, 2002 letter]. See also Report of the Task Force on the Future of Shared State and Federal Securities Regulation (1997), *available at* http://www.nasaa.org/content/Files/Report_Future_of_Shared_Securities_Regulation.pdf.

³ Letter from Joseph P. Borg, President, NASAA President and Director, Alabama Securities Commission to Nancy M. Morris, Secretary, SEC (Apr. 2, 2007) (regarding Securities Act Release No. 33-8766 and Investment Advisers Act Release No. 2576), *available at* <http://www.sec.gov/comments/s7-25-06/s72506-610.pdf> [hereinafter April 2, 2007 letter].

⁴ See April 2, 2007 letter, *supra* note 3.

⁵ Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6339, 46 FR 41791, 1981 SEC LEXIS 924 (Aug 7, 1981) [hereinafter Adopting Release].

⁶ See April 2, 2007 letter, *supra* note 3.

⁷ *Id.*; March 4, 2002 letter, *supra* note 2.

⁸ See April 2, 2007 letter, *supra* note 3.

There is currently very little correlation, if any, between those meeting the existing accredited investor definition and financial qualification. Rapidly increasing real estate values over the past several years have resulted in many home owners meeting the net worth test, regardless of financial qualification. In addition, the ability to accumulate assets in retirement accounts allows aging investors to meet the net worth test, regardless of financial qualification. As a result, leaving the definition at its 1982 levels now (and for the next five years) unnecessarily places at risk investors in locations of substantial real estate appreciation, and the aging population, such as seniors, who have accumulated substantial dollar amounts in retirement accounts, despite little or no genuine financial qualification.

The Release states that the Commission's Office of Economic Analysis estimates that in 1982 only 1.87% of U.S. households met the accredited investor thresholds. That Office now estimates that 8.47% of U.S. households would be accredited investors. The Release offers no explanation as to why issuers today should be permitted to raise money in private securities offerings from a percentage of the population four times that originally contemplated and not otherwise shown to be financially sophisticated and capable of assuming risk.

It concerns NASAA that the effects of inflation and the increase in real property values over the last twenty-five years have made it possible for many individuals to satisfy the accredited investor definition based on the value of their home and other assets without any significant investment decision making experience or the development of a significant investment portfolio. The SEC Chairman himself has testified that the current accredited investor threshold may permit the sale of unregistered securities to individuals who reside where home values have experienced substantial appreciation based largely on the value of their personal residence.⁹ Investors should not be presumed to be financially sophisticated and capable of assuming the risk of an investment in private placement securities when their net worth does not demonstrate that they have significant investment decision making experience or that they have developed a significant investment portfolio. Investors like these should instead be afforded the protections of the registration process.

For these reasons, NASAA again recommends that the current financial thresholds for a natural person to qualify as an "accredited investor" be raised as proposed in our April 2, 2007 letter to one with:

1. \$1,000,000 in investments, and
2. Either:
 - i. A net worth of \$2,000,000 excluding the investor's primary residence; or

⁹ Chairman Christopher Cox, Testimony Concerning the Regulation of Hedge Funds, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006), *available at* <http://www.sec.gov/news/testimony/2006/ts072506cc.htm> (noting that teachers and fire fighters from California may satisfy the definition of accredited investor based on the value of their personal residences and their teacher's or fire fighter's retirement funds).

- ii. Annual individual income of \$300,000, or \$400,000 with that person's spouse.

This recommendation would allow a natural person to meet the “accredited investor” definition with a minimum amount in investments and a minimum net worth, or a minimum amount in investments and a minimum income. It would also raise the net worth and income thresholds from those contained in the 1982 “accredited investor” definition and add a minimum investments threshold to more closely align the definition with a reasonable presumption of financial qualification by contemporary standards.

In addition, in light of the obsolescence of the current definition caused by the substantial appreciation in real estate, the Commission should consider placing a cap on the percentage of personal residence appreciation that can be included in the determination of whether an individual investor satisfies the \$1 million net worth test in the accredited investor definition if the Commission does not follow the recommendation of NASAA contained in this letter to adopt an “investments owned” standard as an additional requirement to the net worth test.

2. NASAA strongly supports the adoption of a disqualification provision applicable to all private offerings under Regulation D, however, the proposed disqualification provision should be broadened enabling regulators to weed out recidivists.

NASAA strongly supports the adoption of a disqualification provision to prevent recidivists from conducting private securities offerings under Regulation D. The adoption of a disqualification provision to apply to all offerings under Regulation D will provide needed investor protection and will not be detrimental to legitimate issuers. It shocks the conscience that recidivists are legally allowed to conduct private securities offerings.¹⁰ This is particularly true given that the SEC did not adopt disqualification provisions under Rule 506 after state regulators were preempted under the National Securities Markets Improvement Act of 1996 from enforcing such provisions to weed out recidivists from Rule 506 offerings.¹¹ In the post-NSMIA world small business issuers are using Rule 506 almost exclusively for Regulation D offerings. It is therefore incumbent upon the Commission to provide this very valuable tool to prevent offerings involving recidivists from being sold in the private placement market at the peril of investors. A disqualification provision should apply to all offerings made under Regulation D, including offerings under proposed Rule 507, to assist states in keeping recidivists from selling securities to residents of their states.

In order to provide adequate investor protection and promote uniformity in federal and state securities regulation, the scope of the disqualification provision should be significantly expanded.

¹⁰ See SEC v. Calvo, 378 F.3d 1211 (11th Cir. 2004).

¹¹ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290; 15 U.S.C. 77r.

- a. An offering should be disqualified if any of the issuer’s officers or beneficial owners of 10% or more of an issuer’s equity securities have violated relevant laws and regulations.**

The proposed disqualification provision should be expanded to disqualify an issuer from making an offering under Regulation D if any officer or beneficial owner having the power to vote or dispose, or direct the vote or disposition of, 10% or more of a class of equity securities of the issuer is subject to disqualification. Beneficial owners and officers of an issuer have long been presumed to hold a degree of control over an issuer and are included in the disqualification provision applicable to Regulation A offerings and offerings under Rule 505 of Regulation D.

The Release provides no justification for the exclusion of non-executive officers and beneficial owners of 10% to up to 20% of any class of an issuer’s equity securities. The fact that “executive” officers and 20% beneficial owners may have “greater influence on the policies of the issuer” than 10% beneficial owners or officers below the executive level does not eliminate the powerful influence 10% beneficial owners and non-executive officers may wield. Further, as noted by the Commission, excluding 10% beneficial owners and officers would be inconsistent with the approach of the Model Accredited Investor Exemption (“MAIE”). It would be detrimental to investor protection and a uniform approach to exclude 10% beneficial owners and officers from any disqualification provision adopted by the Commission.

- b. An offering should be disqualified if an underwriter or control person of the underwriter involved in the offering has violated relevant laws and regulations.**

The Release proposes to exclude underwriters, including broker-dealers and private placement agents, as well as partners, directors, or officers of underwriters from the proposed disqualification provision under Regulation D. The Release rationalizes their exclusion based on the fact that they do not directly control issuers or the decision to conduct an offering.¹² Issuers that sell a securities offering through an underwriter that has violated relevant laws and regulations or that is controlled by persons that have done so must, however, be subject to disqualification because underwriters are more often in contact with the ultimate purchasers and it is thus necessary for the protection of investors to disqualify a private offering that has not been through the registration process if the underwriter involved has violated relevant laws and regulations.

It appears that this concern has not been considered and, instead, the Release focuses on those who are in control of the issuer regardless of their impact on the offering and investor protection. Underwriters have an enormous impact on securities offerings, especially the offerings of small businesses. Consistent with the protection of investors, the proposed disqualification provisions should prohibit private offerings under Regulation D that involve underwriters that have violated relevant laws and regulations

¹² Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45,116, 45,131 (Aug. 10, 2007) (to be codified at 17 C.F.R. pts. 200, 230, and 239) [hereinafter Release].

or that have a partner, director, or officer that has violated relevant laws and regulations. We would not object, however, to the exemption from such a disqualification provision where the person that would otherwise disqualify the offering under the proposed rule “continue[s] to be licensed or registered to conduct securities related business in the jurisdiction where the order, judgment, or decree creating the disqualification was entered, as is the case in the Model Accredited Investor Exemption.”¹³

There are other reasons to include underwriters and their control persons in any disqualification provision that is ultimately adopted. Subjecting an offering to disqualification based on the past disciplinary history of underwriters and partners, directors, and officers of an underwriter would encourage issuers to screen those selling their securities. Excluding underwriters and their partners, directors, or officers from the proposed disqualification provision is also inconsistent with the MAIE and existing federal law.

c. An offering should be disqualified if any relevant person has made a false filing with a state.

Although the Release does not explain why an issuer would not be disqualified from conducting a Regulation D offering if one of the specified persons has made a false filing with a state, we presume the rationale for this exclusion is rooted in the exclusion of false filings with states and other state related disabilities in the current disqualification provision applicable to Regulation A and Rule 505 offerings. The adopting release for Regulation D indicates that state related disabilities were excluded on the basis that states would include state related disabilities in exemptions designed to coordinate with the Regulation D exemptions.¹⁴ After the adoption of Regulation D, however, states were preempted from imposing disqualification provisions on offerings conducted under Rule 506 and would be similarly preempted in connection with offerings under proposed Rule 507.¹⁵ A false filing with a state regulator is no less egregious than a false filing with the Commission. For these reasons, any disqualification provision adopted should include false filings with states.

d. An offering should be disqualified if any relevant person has been convicted of any criminal offense involving fraud or deceit, the making of a false filing with a state, or that otherwise indicates that an offering should be registered in order to protect investors.

The proposed disqualification provision should be revised to disqualify an offering if any of the relevant persons has been convicted within the last ten years of a criminal offense involving fraud or deceit, the making of a false filing with a state, or involving a commodity future or option contract, or an aspect of a business involving securities, commodities, investments, franchises, insurance, banking or finance. The Release does

¹³ *Id.* at 45,133.

¹⁴ Adopting Release, *supra* note 5 at *11-12.

¹⁵ 15 U.S.C. § 77r.

not justify the exclusion of these crimes from the proposed disqualification provision although they are included in the MAIE and the Uniform Securities Act of 2002 (“USA (2002)”) with the exception of crimes stemming from making a false filing with a state.¹⁶ Convictions involving the making of a false filing with a state should also be included in the disqualification provision because such a filing is just as egregious as making a false filing with the Commission. The fact that a person involved in the offering has been convicted of such a crime within the past ten years raises concerns that the person may not comply with laws and regulations concerning the offer and sale of securities. For the protection of investors and the benefit of uniformity, the proposed disqualification provision should be revised to include convictions for these types of crimes within the last ten years.

- e. Disqualification based on adjudications and determinations, as well as orders, judgments and decrees of courts and regulatory agencies should not be limited to those entered within the last 5 years where they remain effective or unsatisfied.**

The proposed disqualification provision should remove the qualifiers limiting disqualification on the basis of relevant adjudications or determinations, or orders, judgments or decrees of courts and regulatory agencies to those “within the last 5 years.” Instead the disqualification provision should apply where a person remains subject to an adjudication or determination or an order, judgment or decree of any court of competent jurisdiction or relevant regulatory agency consistent with language contained in §412 of the USA (2002) and the protection of investors. Requiring an issuer to apply for registration in this context would allow regulators the opportunity to evaluate whether the offering documents provide adequate disclosure of these items or, in the alternative, whether an offering should be denied registration. For these reasons, proposed Rule 502(e)(1)(iii)-(v) should be revised to remove the qualifiers limiting disqualification based on the enumerated actions to those “entered within the last 5 years.”

- f. The proposed disqualification provision should include relevant violations and other actions based on franchise laws consistent with the protection of investors and uniformity.**

Because violations of franchise laws may indicate a propensity to violate similar provisions contained in securities laws, proposed Rule 502(e)(1)(iii)-(v) should be revised to include violations and actions based on violations of franchise laws.

- g. The proposed disqualification provision should disqualify an issuer from making a private offering under Regulation D based on relevant foreign actions.**

¹⁶ The MAIE disqualifies an issuer from using the exemption if any of the relevant persons “within the last five years, has been convicted of any criminal offense in connection with the offer, purchase or sale of any security, or involving fraud or deceit.” MODEL ACCREDITED INVESTOR EXEMPTION § (D)(1)(b). *See also* USA (2002) § 412(d)(3), (d)(11)(A).

The proposed disqualification provision should be further revised to provide that an issuer is disqualified from making a private offering in reliance on Regulation D where the issuer has been the subject of a relevant foreign action. We suggest the disqualification be revised to include a disqualification provision with language similar to that contained in USA (2002) § 412(d)(11), which provides an administrator with authority to take disciplinary action against an applicant or registrant that:

after notice and opportunity for a hearing, has been found within the previous 10 years:

- (A) by a court of competent jurisdiction to have willfully violated the laws of a foreign jurisdiction under which the business of securities, commodities, investment, franchises, insurance, banking, or finance is regulated;
- (B) to have been the subject of an order of a securities regulator of a foreign jurisdiction denying, revoking, or suspending the right to engage in the business of securities as a broker-dealer, agent, investment adviser, investment adviser representative, or similar person; or
- (C) to have been suspended or expelled from membership by or participation in a securities exchange or securities association operating under the securities laws of a foreign jurisdiction.

Because foreign actions are no less relevant in the context of a private offering than domestic actions, an issuer that would be subject to disciplinary action under this provision should not be permitted to conduct a private offering under Regulation D and deprive investors of the protections afforded by the registration process. For the same reason, we urge the revision of proposed Rule 502(e)(1)(i) to include administrative orders entered under the securities laws of foreign jurisdictions.

h. The proposed disqualification provision should disqualify an issuer from making a private offering under Regulation D based on other relevant regulatory actions.

The proposed disqualification provision should be revised to include other regulatory actions that are relevant in the context of a securities offering. We suggest revising proposed Rule 502(e) to include a disqualifier based on an order of a court adjudicating a United States Postal Service fraud order.¹⁷ In our experience as state securities regulators, in cases we refer to U.S. Attorneys, it is not uncommon for them to prosecute or negotiate plea agreements in “securities” cases based on mail fraud charges. An issuer that is subject to a postal service fraud order should not be permitted to conduct a private securities offering and should instead be required to register consistent with the protection of investors. Registration will allow regulators to deny registration where

¹⁷ USA (2002) § 412(d)(5).

appropriate or to ensure that sufficient disclosure of past violations is provided in the offering documents.

- i. The exemption from the disqualification provision based on the issuer's lack of knowledge of disqualification should be expressly conditioned on the issuer having made a factual inquiry as required by the MAIE.**

An issuer should not be permitted to rely on Regulation D and the exemption from the disqualification provision where the issuer failed to discover that a disqualification existed unless the issuer made a factual inquiry as to whether a disqualification existed. In order to make it clear to small business issuers that they must make a factual inquiry as to whether a disqualification exists, Rule 502(e)(2) should be revised to expressly provide that the exemption from disqualification is only available where the issuer did not know, and in the exercise of reasonable care could not have known, based on a factual inquiry, that a disqualification existed.

- j. The exemption from the disqualification provision based on a waiver by the Commission where good cause is shown should also be conditioned upon a finding by the Commission that a waiver will not be prejudicial to an action by a state or other regulator.**

While we do not object to a waiver of the disqualification by the Commission where good cause is shown and it would not prejudice any other action by the Commission, a waiver should also be conditioned on a finding that it would not prejudice an action by a state or other securities regulator. In addition, a waiver should not prejudice other state administrative, injunctive or criminal actions. Without such a provision, the Commission may be placed in the awkward position of granting a waiver while another action is pending. In the interest of regulatory cooperation, the proposed waiver provision should be conditioned accordingly.

- k. Mandatory disclosure is not an appropriate substitute for disqualification.**

NASAA strongly submits that mandated disclosure of the existence of a disqualification is not an appropriate substitute for disqualification.¹⁸ Requiring recidivists to apply to register a securities offering permits regulators to deny registration to otherwise unrestrained violators and to require appropriate disclosure to investors if registration is granted. In the absence of regulatory oversight, investors may not receive appropriate disclosure of past disciplinary issues even where such disclosure is mandated. Those who have already had action taken against them for violating the securities laws should not be given a chance to do so again without submitting to the registration process consistent with the protection of investors.

¹⁸ See Release, *supra* note 12 at 45,133.

l. NASAA opposes the incorporation of a grandfathering provision for the proposed disqualification provision.

Recidivists should never have been permitted to participate in private offerings as their involvement is inconsistent with the protection of investors. For these reasons, NASAA opposes any further delay in the implementation of disqualification provisions, including through the adoption of a grandfathering provision.

m. NASAA conditionally supports the revision of Regulation A and Regulation E disqualification provisions in the interest of uniformity.

If the proposed disqualification provision is revised in a manner consistent with the comments set forth in this letter, NASAA supports the revision of the disqualification provisions set forth in Regulations A and E for the sake of uniformity.

3. NASAA opposes shortening the waiting period between private offerings to a mere 90 days as this change would undermine the need to register with state and federal securities regulators.

NASAA does not support reducing the integration safe harbor period to 90 days before and after an offering conducted under Regulation D, as this reduction would permit issuers to conduct serial private offerings and circumvent the protections afforded to investors by the registration process. Based on the recommendation of the Advisory Committee on Smaller Public Companies (“Advisory Committee”), the Commission proposes to reduce the integration safe harbor period established in 1982.¹⁹

The Advisory Committee’s recommendation was made based on assertions that the existing integration rules create uncertainty and inflexibility. The integration safe harbor periods set forth in Regulation D do just the opposite, however, providing certainty to issuers that multiple offerings will not be integrated if sufficient time has passed to ensure the offerings are not part of a single plan of financing or part of a scheme to avoid registration.²⁰ While shortening the integration periods would provide no greater clarity than the present rules, it would allow issuers to conduct more offerings without registration and the protections afforded investors through the registration process. Finally, while the current rules do not allow issuers the flexibility to conduct serial private offerings, they do provide sufficient flexibility to permit multiple securities offerings in a one-year period.²¹

¹⁹ Adopting Release, *supra* note 5.

²⁰ The Release itself notes that the current integration safe harbor period “provides issuers with a bright-line test upon which they can rely to avoid integration of multiple offerings” and “has worked well to clearly differentiate two similar offerings and provide time for the market to assimilate the effects of the prior offering.” Release, *supra* note 12 at 45,130.

²¹ An issuer can easily conduct two private offerings in a one-year period while relying on the six-month integration safe harbor period. Further, offerings made outside the United States in compliance with Regulation S and offers and sales under an employee benefit plan as defined in Rule 405 are not integrated with Regulation D offerings. Rule 502(a). *See also*, Letter from Patricia D. Struck, NASAA President and

In addition to the clarity and flexibility provided by the current six-month safe harbor period, the current integration safe harbor also ensures that an issuer sells securities to no more than a small number of non-accredited investors in private offerings. An issuer that sells securities to a large number of non-accredited investors in a short timeframe should be required to register the securities in order to provide these investors the protections of the registration process as Congress and state legislatures intended.

The Release offers other similarly unconvincing reasons for shortening the integration safe harbor period. The Release provides no evidence to establish that the unpredictability of smaller companies' financing needs is a new phenomenon not present at the time the current integration period was established. The Release comments that volatility in the capital markets and advances in information technology may have changed the landscape of private offerings, but these are not reasons to uproot the current integration rules that the Commission readily admits are working well in this landscape. The fact that technology and modern capital markets make it possible to sell securities faster and more frequently than twenty-five years ago does not mean that issuers ought to be able to do so in private offerings.

The Release also indicates the Commission's desire to strike "an appropriate balance between the number of non-accredited investors allowed in an offering relying on the integration safe harbor and the non-public nature of that offering."²² We submit that the balance was struck appropriately with the existing safe harbor. Absent a clear showing that the six-month time frame is causing unwarranted harm, the long established and clear integration period in Rule 502(a) should remain untouched.

Extending the drastically reduced integration safe harbor period proposed in the Release to offerings permitting a limited public announcement under proposed Rule 507 would present a clear opportunity for abuse. As posited by the Commission, issuers could use the general announcement permitted under proposed Rule 507 to test the waters before undertaking an exempt offering under Regulation D. It would be unacceptable for an issuer to be permitted to test the waters in this manner or to conduct limited public solicitation every 90 days without ensuring that investors are provided the protections afforded by the registration process. For these reasons, any modification of the current integration safe harbor period should not apply to offerings under proposed Rule 507 as well as under current Rules 504, 505 and 506.

4. NASAA supports the adoption of an "investments-owned" standard in the definition of accredited investor and specific aspects of that proposal; however, further refinements are necessary to ensure issuers may sell securities in private offerings only to financially sophisticated investors.

Wisconsin Securities Administrator, to Nancy M. Morris, Federal Advisory Committee Management Officer (Mar. 28, 2006) (regarding the Exposure Draft of the Advisory Committee on Smaller Public Companies), *available at* <http://www.sec.gov/rules/other/265-23/rastaples1692.pdf> [hereinafter March 28, 2006 letter].

²² Release, *supra* note 12 at 45,130.

NASAA supports the adoption of an “investments-owned” element in the accredited investor definition. Such a test may more accurately assess whether an investor is presumptively financially sophisticated and capable of assuming the risk of an investment in a private securities offering. NASAA submits the following comments in connection with the proposal.

- a. An “investments-owned” standard should be a required element of the accredited investor definition, not an alternative test, and the threshold for natural persons should be raised.**

Rather than constituting an alternative test for permitting issuers to sell securities in private offerings to natural persons, the “investments-owned” standard should be added to the current net worth and income tests. With this approach, the Commission would move forward significantly toward better identifying sophisticated investors. Further, the addition of an “investments-owned” standard should be coupled with increases in the net worth and income standards as discussed above. The addition of an “investments-owned” standard as an alternative test without raising the current income and net worth standards would fail to have any impact; issuers will likely continue to rely on the eroded standards which would be unchanged under the proposal. Without raising the net worth and income standards there would be no balancing of the needs of small business capital formation with investor protection because a large portion of the current pool of accredited investors will continue to be financially unqualified in real terms.

The proposed alternative individual or joint investments threshold of \$750,000 is too low to support the notion that an individual is presumptively financially sophisticated in the context of a private securities offering. As discussed at Item 1 above, the dollar amounts currently used and those proposed to determine whether a natural person is sophisticated, including the net worth, income or investments-owned standards, are inadequate by modern standards. For this reason, NASAA recommends that the proposed alternative “investments-owned” threshold be raised to \$1,000,000 for natural persons.

- b. NASAA supports the reduction for investment-related indebtedness in the proposed definition of “investments.”**

NASAA supports the definition of investments in proposed Rule 501(h) which provides that investments would be calculated net of investment indebtedness. An investment portfolio that is heavily margined or that required the investor to otherwise become indebted in order to finance the investment should be valued net of indebtedness in determining whether an investor is presumptively financially sophisticated to invest in a private securities offering.

- c. The proposed definition of “investments” should be revised to clarify that investments are valued at the lower of cost or fair market value and that the “investments-owned” standard properly accounts for investments that have declined in value.**

If the Commission adopts an “investments–owned” standard for determining accredited investor status, Note 3 to the proposed definition of “investments” should be revised to clarify that investments are valued at the *lower of* cost or fair market value.

5. NASAA commends the Commission’s proposal to permit limited solicitation in connection with proposed Rule 507, but further refinements are necessary in order to balance capital formation with investor protection.

NASAA supports the adoption of a rule permitting limited general solicitation of financially qualified investors that would help businesses raise capital without sacrificing investor protection. As evidenced by the numerous states that have adopted the MAIE, we believe that an exemption for offers and sales to certain accredited investors that permits limited public solicitation assists in the capital formation process for companies while providing important investor protections through the various conditions to the exemption. These protections include limitations on public solicitation and the prohibition on an issuer’s ability to sell to those who are not presumptively financially qualified and capable of assuming risk.

NASAA is very pleased that after all the years we have sought a federal exemption to coordinate with the MAIE, the Commission has responded with a proposed rule to allow limited public solicitation to qualified investors. However, an unregistered offering that permits limited general solicitation should be balanced against the interests of investor protection. We urge the Commission to revise proposed Rule 507 in accordance with the following comments.

a. The income thresholds for “large accredited investors” in Rule 507 offerings should be higher than the inflation adjusted income thresholds for accredited investors.

Issuers should only be able to sell securities in limited offerings under proposed Rule 507 to investors that are presumptively financially qualified and capable of assuming the risk of the investment. We commend the Commission for looking to the USA (2002) and choosing a threshold for entities that will aid in furthering federal and state uniformity. We are concerned, however, that the financial thresholds proposed for natural persons are inadequate to protect individual investors in the context of general solicitation.

NASAA supports the \$2.5 million investments owned standard proposed by the Commission for investors under proposed Rule 507.²³ The proposal falls short, however, by proposing an alternative income test with thresholds that merely take into account the inflationary impact on the original accredited investor income thresholds that were based

²³ In the Release, the Commission refers to a previous letter from NASAA and asks whether it should adopt for individuals a threshold of \$1 million in investments to qualify as a large accredited investor. The question refers to *only a part* of NASAA’s proposed definition for an “eligible purchaser” in connection with a previously proposed exemption involving general solicitation. Specifically, NASAA suggested that only a person with \$1 million in investments *and* \$2 million in net worth exclusive of primary residence be defined as an “eligible purchaser” for the purposes of that proposal.²³ In proposed Rule 507, however, the Commission should retain its proposed \$2.5 million investments–owned threshold for individuals.

on income levels in 1982. The proposed definition of “large accredited investor” should be revised so that any thresholds for an alternative income test do more than merely reflect the inflationary impact on the original accredited investor thresholds.

b. Proposed Rule 507 should be revised to specify the description of “large accredited investor” to be included in the limited announcement.

Consistent with the MAIE, NASAA supports the inclusion of a “description of what ‘large accredited investor’ means” in the limited announcement permitted under proposed Rule 507.²⁴

Requiring only a “description,” rather than a specific definition, may, however, present problems. An issuer’s “description of what ‘large accredited investor’ means” could end up including misleading language or an improper attempt to make a market for the issuer’s securities. Moreover, in the absence of a specific word limit or boilerplate language, issuers and regulators may disagree over an advertisement’s compliance with the proposed rule and, consequently, qualification as a covered security.²⁵

We recommend that the Commission either limit the words allowed to describe a large accredited investor or specifically define the permissible description.

c. NASAA strongly supports prohibiting sales to persons who do not qualify as “large accredited investors” in offerings conducted in reliance on Rule 507.

NASAA strongly supports the Commission’s proposal to prohibit sales to those that do not qualify as large accredited investors in Rule 507 offerings. The proposed prohibition is consistent with the MAIE, which has been adopted by at least 30 states. Issuers should not be permitted to conduct general solicitation to attract individuals who do not meet the thresholds for large accredited investors. Instead, these individuals should be provided the protections afforded by the registration process for publicly offered securities.

NASAA does not object to the use of password-protected websites to limit sales to large accredited investors. However, the use of these websites does not supplant the duty of issuers to make a reasonable inquiry to determine that anyone solicited through such a website is a “large accredited investor.”²⁶

6. NASAA does not oppose adding the proposed specific categories of entities described in the Release to the list of accredited and large accredited investors.

²⁴ See Release, *supra* note 12 at 45,144.

²⁵ See, e.g., *Risdall v. Brown-Wilbert, Inc.*, 733 N.W.2d 827 (Minn. App. 2007); *In re Blue Flame Energy Corp.*, 871 N.E.2d 1227 (Oh. App. 2006); and *Temple v. Gorman*, 201 F.Supp.2d 1238 (S.D. Fla. 2002).

²⁶ See, e.g., 17 C.F.R. § 230.144A(d)(1).

The added categories of entities to the list of accredited and large accredited investors do not raise investor protection concerns if the Commission increases the minimum assets required for these entities to \$10 million. The Commission should also clarify the meaning of “Indian tribes” and “labor unions” to avoid uncertainty.

The Commission proposes to amend the definition of accredited investors to include limited liability companies, Indian tribes, labor unions, governmental bodies, and other legal entities with substantially similar legal attributes. This change will eliminate arbitrary distinctions based on the organizational types of various entities, where there is no correlation between the form of the entity and the need for the protections of securities registration. We note, however, that adding these organizations to the definition of accredited investors presumes they all have the financial qualification to protect themselves in a securities transaction. Because the threshold of \$5 million in minimum assets for these entities has not been adjusted for inflation in many years, NASAA recommends that a more appropriate threshold for minimum assets is \$10 million. In addition, we recommend that the terms “Indian tribe” and “labor union” be defined, in order to avoid uncertainty and assist in enforcement of the rules.

In addition to the foregoing, the Commission has requested comments on whether it should consider all institutions that would come under Rule 501(a)(3) and that meet the \$100 million investment size threshold under Rule 144A as having sufficient experience with the resale market for restricted securities, and thus be included in the list of qualified institutional buyers in Rule 144A(a)(1)(i)(H). NASAA does not object to the Commission expanding the Rule 144A(a)(1)(i)(H) list of qualified institutional buyers similar to the amendments to Rule 501(a)(3), provided that all of the buyers meet the \$100 million investment size threshold under Rule 144A to participate in the resale market for restricted securities.

7. NASAA supports the proposed definition of accredited natural person for private pooled investments.

As provided in the April 2, 2007 letter, NASAA continues to support the proposed heightened financial thresholds for individual investors to invest in private pooled investments, the proposed \$2.5 million in investments threshold, the proposed definition of “investments,” the proposed investments test as an additional test to the current accredited investor tests rather than an alternative test, and the proposed inflationary adjustment every five years.²⁷

In the Release, the Commission requests additional comments on whether it should revise the proposed definition of accredited natural person²⁸ to include alternative income and investment standards similar to those used in the definition of “large accredited investor” in proposed Rule 507 (income of \$400,000 [or \$600,000 with one’s spouse] or

²⁷ April 2, 2007 letter, *supra* note 3.

²⁸ See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles; Securities Act Release No. 33-8766; Investment Advisers Act Release No. 2576, File No. S7-25-06, 72 FR 400 (Jan. 4, 2007).

investments of \$2.5 million). NASAA believes that the original proposal to define an accredited natural person as one with \$2.5 million in investments, excluding a principal residence, is a superior method to qualify as an accredited investor for purposes of investing in certain private pooled investment vehicles. The income thresholds referenced in the Release do nothing more than take into account the impact of inflation over the last twenty-five years; they are not adequate to ensure an investor is presumptively financially sophisticated and capable of assuming risk, particularly in the context of an investment in a private pooled investment vehicle.

Because investors in these funds do not receive prospectuses or benefit from the other protections afforded by the securities registration process, individuals who invest in these funds should be capable of both evaluating the merits and risks of these investments and withstanding losses. While no standard is foolproof, we agree that the additional and higher investment-owned standard proposed in the definition of accredited natural person is intended to provide a more objective and clearer standard to use in ascertaining whether an individual is likely to have sufficient knowledge and experience in financial and business matters to enable that investor to evaluate the merits and risks of a prospective investment in certain private pooled investment vehicles, or to be able to hire someone with such knowledge and expertise to assist the individual to make such an evaluation. Introducing a lower, alternative standard would only dilute that protection. Nevertheless, while an alternative income standard is not favored, if one is adopted, a higher income standard than currently proposed is essential in the interest of investor protection in light of the undisclosed conflicts of interest, complex fee structures and the higher risks associated with these investments.

8. The adoption of resale restrictions on Rule 504 offerings would contribute to uniformity and provide greater investor protection.

NASAA supports the adoption of resale restrictions on securities sold in offerings made under Rule 504 that are not registered at the state level.²⁹ The adoption of a resale restriction applicable to securities sold in offerings under Rule 504 would serve to help prevent issuers from using Rule 504 as a means to avoid registration at the expense of investors. Certain state registration exemptions have been abused when used in coordination with Rule 504 offerings where it has been falsely represented to investors that the securities are freely tradable securities.³⁰ A resale restriction for Rule 504 offerings would also contribute to uniformity by applying to all Rule 504 offerings that are not registered at the state level.

²⁹ We have commented separately on the proposed changes to Rules 144 and 145. Letter from Joseph P. Borg, NASAA President and Director, Alabama Securities Commission, to Nancy M. Morris, Secretary, SEC (Sept. 24, 2007) (regarding proposed revisions to Rules 144 and 145 to shorten the holding period for affiliates and non-affiliates for resales of restricted securities), *available at* <http://www.sec.gov/comments/s7-11-07/s71107-36.pdf>.

³⁰ The Commission recently filed a civil complaint against several individuals and entities for freely trading Rule 504 securities in a classic “pump and dump” scheme. *See* Litigation Release No. 20302, Sept. 27, 2007, at <http://www.sec.gov/litigation/litreleases/2007/lr20302.htm>.

9. The text of the proposed amendments to Rule 146 concerning state notice filing requirements should be revised to more closely adhere to the language of Section 18(c)(2)(A).

The Commission has proposed Rule 507 under the authority of Section 28 of the Securities Act. In order to extend covered security status to securities sold under proposed Rule 507, the Commission has also proposed to define “qualified purchaser” under Section 18(b)(3) of the Securities Act as “any large accredited investor...with respect to an offer or sale in compliance with [proposed Rule 507].” While Congress preempted states from requiring registration or qualification of covered securities in passing NSMIA, it also expressly preserved the ability of states to require a notice filing with respect to covered securities in section 18(c)(2)(A), which provides:

Nothing in this section prohibits the securities commission (or any agency or office performing like functions) of any State from requiring the filing of any document filed with the Commission pursuant to this title, together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State (if such sales data is not included in documents filed with the Commission), solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee.

The Commission has proposed to require a notice filing for securities offered and sold in reliance on proposed Rule 507 and seeks to address the preservation of state notice filing requirements by amending Rule 146 to define “qualified purchaser” with a proviso that the Rule “does not prohibit a state from imposing notice filing requirements that are substantially similar to those imposed by the Commission for transactions with such investors.” So as not to raise any question as to whether the Commission has exceeded the authority granted to it by Congress, the Commission should revise the proposed amendments to Rule 146 to cite the language used in Section 18(c)(2)(A).

Thank you for considering our comments on the proposals contained in the Release. The issues are as important as they are vast. Regulation D is long overdue for revision and we urge the Commission to extend the scope of the proposals to bring meaningful protection to investors.

Should you have any questions regarding the comments in this letter, please contact the undersigned or Rex Staples, General Counsel for NASAA, at rs@nasaa.org or (202) 737-0900 x.107 or Michael E. Stevenson, Securities Administrator for the State of Washington and out-going Chair of NASAA’s Corporation Finance Section, at mstevenson@dfi.wa.gov or (360) 902-8824, or Mark Connolly, Director of Securities Regulation and in-coming Chair of NASAA’s Corporation Finance Section, at mconnolly@sos.state.nh.us or (603) 271-1463.

Sincerely,



Karen Tyler
NASAA President and
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