



NASAA

**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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April 2, 2007

VIA E-MAIL: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

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

**Re: File No. S7-25-06  
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, 72 FR 400 (Jan. 4, 2007)**

Dear Ms. Morris:

The North American Securities Administrators Association (NASAA)<sup>1</sup> appreciates the opportunity to comment on the above referenced release (“Release”). We take this opportunity to comment because state regulators are concerned with the explosion of hedge fund offerings and the inadequate financial thresholds for investors purchasing them.

**1. NASAA strongly supports raising the financial thresholds for investors in hedge funds (proposed Rules 216 and 509).**

NASAA shares the concerns expressed in the Release with respect to the risks of investing in hedge funds and investment pools (“hedge funds”). Hedge funds are known for employing high risk investment strategies and for not disclosing these strategies to prospective investors.<sup>2</sup> Hedge fund investments are generally sold in private offerings and thus investors in these funds do not receive prospectuses or enjoy the other protections afforded by the securities registration process. For these reasons, individuals who invest in hedge funds should be capable of both evaluating the merits and risks of these investments and withstanding losses.

NASAA agrees that the current financial thresholds for many investors who invest in hedge funds and other similar funds as “accredited investors” are neither adequate to ensure these individuals are capable of evaluating the merits or risks of these investments nor sufficient to ensure they can withstand the loss of their investment. As noted in the Release and raised by

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (“NASAA”) 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.

<sup>2</sup> 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> (summarizing recent enforcement cases involving, among other things, inaccurate disclosure of trading strategies) [hereinafter Chairman Cox].

NASAA in the past,<sup>3</sup> inflation has seriously eroded the efficacy of these thresholds since their adoption in 1982. As NASAA commented in 2002, many individuals satisfy the definition of “accredited investor” based on the equity in their homes and years of regular contributions to retirement plans, neither of which directly demonstrates financial sophistication.<sup>4</sup>

NASAA believes the additional financial criteria contained in proposed Rules 509 and 216 would provide a greater degree of investor protection. In addition to the requirements applicable to natural persons under the current definition of “accredited investor,” the proposed rules would require that natural persons have “investments” of \$2.5 million in order to qualify as an “accredited natural person” for purposes of investing in a hedge fund. The definition of “investments” would exclude an individual’s personal residence and property used in a trade or business. NASAA supports these proposals because they would establish a higher financial threshold and exclude assets from the suitability determination that do not demonstrate a high degree of financial sophistication and may not be suitable to liquidate in the event of investment losses. We also support the adjustment of the required amount of investments every five years for inflation. The inclusion of an inflation adjustment in the rules promises to ensure that the protections sought for hedge fund investors will not be seriously eroded by the effects of inflation as is the case under the current definition of “accredited investor.” Because the Commission’s proposals are more likely than the current rules to ensure that investments in hedge funds by natural persons are suitable, NASAA strongly supports the proposed rules.

## **2. The financial thresholds for investors in all private offerings should be raised (Rules 501(a) and 215).**

NASAA not only generally supports the rules proposed in the Release, NASAA also submits that the financial thresholds should be raised for natural persons investing in private offerings. In particular, NASAA proposes that the Commission raise the current financial thresholds for natural persons who qualify as “accredited investors”<sup>5</sup> to those with:

1. \$1,000,000 in “investments,” as defined in the proposed rules;<sup>6</sup> and
2. Either:
  - a. A net worth of \$2,000,000 excluding the investor’s primary residence; or
  - b. Individual income of \$300,000 or \$400,000 with that person’s spouse.<sup>7</sup>

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

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3 Letter from Joseph P. Borg, NASAA President and Director of the Alabama Securities Commission, to Jonathan G. Katz, Secretary, SEC, Mar. 4, 2002, available at <http://www.sec.gov/rules/proposed/s72301/borg1.htm> (expressing our concerns with the Rule 501 standards).

4 *Id.* See also, Chairman Cox, *supra* note 2 (noting that teachers and firefighters from California could invest in a hedge fund based on the values of their personal residences and their teacher’s or fire fighter’s retirement funds).

5 Rule 501(a) of Regulation D; Securities Act Rule 215.

6 NASAA notes that if this standard were adopted in addition to a requirement that a hedge fund investor have a higher amount of “investments” in order to qualify as an “accredited natural person,” the amount of investments a hedge fund investor must have beyond those required of an “accredited investor” might be adjusted downward to \$1.5 million.

7 These thresholds should be subject to a built-in inflation adjustment like that contained in the proposed rules, thereby avoiding the current situation in which the standards become inadequate.

registration”<sup>8</sup> when investing in private offerings.<sup>9</sup> While those standards may have made sense twenty-five years ago, they are largely inadequate today. The income and net worth standards have not been adjusted for inflation a single time since their adoption. We agree with the observation in the Release that many people who satisfy today’s definition of “accredited investor” lack the wealth and presumed sophistication once ensured by the definition. NASAA submits that all private issuers, not just hedge funds, should be required to confirm that their investors satisfy income and net worth standards likely to ensure financial sophistication and the ability to withstand investment losses.

NASAA points out that the concerns expressed in the Release regarding conflicts of interest, product complexity, and the degree of risk associated with hedge fund investments are true with respect to many private securities investments. In reality, the need for increasing the accredited investor standards is of greater importance for the protection of all private investors than just for those investing in hedge funds. Many hedge funds and similar investment pools are managed by professional managers and many of them are registered investment advisers. Some of them have prior experience with broker-dealers, investment bankers, mutual funds, and pension funds. Private offerings are conducted by a wide range of companies, including start-up and developmental stage companies whose managers have no investment or business experience or credentials and obtain little or no professional assistance.

Finally, we note that investors who do not meet the standards proposed by NASAA for all accredited investors, or the “accredited natural person” standards proposed by the SEC, are not foreclosed from investing in the wide array of registered investment vehicles available in the public markets. If hedge funds and pooled investments wish to sell securities to investors who do not meet the proposed standards, they may register a public offering of hedge fund securities.<sup>10</sup>

For these reasons, the financial thresholds that currently apply for all natural persons to qualify as “accredited investors” for purposes of investing in private offerings should be enhanced by increasing the net worth and income thresholds and, especially, by adopting an investment ownership component.

### **3. NASAA urges the adoption of disqualification provisions for Rule 506 offerings.**

Prior to the enactment of the National Securities Markets Improvement Act of 1996, states screened offerings made in reliance on Rule 506 for disqualified persons.<sup>11</sup> Preemption has made it feasible for otherwise disqualified issuers to promote hedge funds and other private offerings, bypassing the state registration and exemption process and the protections it affords investors.

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<sup>8</sup> 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).

<sup>9</sup> A natural person is deemed an “accredited investor” if that person has an individual net worth, or joint net worth with their spouse, of \$1,000,000 or if that person has an individual income of \$200,000, or joint income with their spouse of \$300,000. Rule 501(a) of Regulation D; Securities Act Rule 215.

<sup>10</sup> We note the recent initial public offering of a hedge fund by Fortress Investment Group. Grace Wong, *Fortress Execs Hit \$10 Billion Jackpot*, CNNMONEY.COM, Feb. 9, 2007, <http://money.cnn.com/2007/02/09/markets/ipo/fortress/index.htm?postversion=2007020918>.

<sup>11</sup> See federal Rule 505 and NASAA’s Uniform Limited Offering Exemption.

NASAA strongly advances the need for the adoption of disqualification provisions under Rule 506 of Regulation D for “bad actors” and other disqualified persons. To protect investors in all private offerings, the Commission should incorporate disqualification provisions in Rule 506 at least as comprehensive as those contained in Rule 505 and the Uniform Limited Offering Exemption (ULOE). These disqualification provisions prohibit a variety of “bad actors” from avoiding the securities registration process by utilizing an exemption from registration. For example, those disqualified from using the private offering exemptions contained in Rule 505 and the ULOE include:

- individuals convicted of a felony or misdemeanor within the past ten years involving the purchase or sale of a security or involving fraud or deceit, including forgery, embezzlement, and larceny;
- those with an administrative order or judgment entered against them within the past five years by a securities regulatory authority or other regulatory authority where fraud or deceit was involved; and
- those that are subject to an order or judgment of a securities regulatory authority denying or revoking the use of an exemption from registration.

Unfortunately, after NSMIA, offerings conducted under Rule 506 allow these “bad actors” to avoid both the federal and state registration processes and to sell securities to investors who may not be aware of their troubled pasts. This also results in inconsistent regulation because the disqualification provisions currently applicable to private offerings under Rule 505 are not also applicable to offerings made in reliance on Rule 506. NASAA urges the adoption of a disqualification provision under Rule 506 because all investors, those entering investment pools and hedge funds as well as those investing in other offerings under Rule 506, need protection from “bad actors” and other disqualified issuers and promoters.

**4. NASAA supports the proposed anti-fraud rule applicable to advisers to pooled investment vehicles, including hedge funds (proposed Rule 206(4)-8).**

NASAA supports the proposal in the Release to adopt a new anti-fraud rule under Section 206(4) of the Investment Advisers Act that would make it unlawful for an investment adviser to any pooled investment vehicle to make materially false or misleading statements to investors or to otherwise engage in fraud.

We support increasing the scope of the anti-fraud rules to protect investors from fraudulent statements and other conduct not clearly covered by present law. Investor protection suffers when investment advisers make fraudulent statements with impunity. The proposed rule would allow the SEC to take action for all materially false or misleading statements made by investment advisers to investors and prospective investors and for other fraudulent conduct. We agree that the SEC should not be required to show that the statements or fraudulent activity to be actionable occurred in connection with the offer or sale of securities or were made to or committed against current “clients,” or that the investment adviser is federally registered. In the absence of the proposed rule, advisers are free to argue that statements made to investors that often influence their decision to utilize the services of the investment adviser or to invest in a hedge fund are not actionable. NASAA believes it is important that statements, which may include false or misleading statements regarding the investment strategies of the investment

adviser, the investment adviser's experience, the risks associated with an investment (including hedge fund investments), valuations, and portfolio allocations, should be subject to this type of regulatory oversight.

The Commission has specifically requested comment on whether the proposed anti-fraud rule should apply to advisers registered or required to register at the state level and to advisers of all pooled investment vehicles. NASAA supports the application of the proposed rule to advisers registered or required to register at the state level. NASAA also supports the application of the proposed anti-fraud rule to investment advisers of all pooled investment vehicles because every investor should be protected from fraud regardless of the investor's wealth, sophistication, or investment experience.

Thank you for considering our comments on the proposed rules and the issues surrounding the Release. Should you have any questions regarding the comments contained in this letter, please contact the undersigned or Michael Stevenson, Securities Administrator for the State of Washington and Chair of NASAA's Corporate Finance Section, at [mstevenson@dfi.wa.gov](mailto:mstevenson@dfi.wa.gov) or (360) 902-8760.

Sincerely,

A handwritten signature in black ink, appearing to read "JP Borg", with a stylized flourish at the end.

Joseph P. Borg  
NASAA President and  
Director, Alabama Securities Commission