NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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March 4, 2002

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street NW
Washington DC 20549-0609

Re: Definition of Qualified Purchaser; Release No. 33-8041
File No. S7-23-01

Dear Mr. Katz:

The North American Securities Administrators Association, Inc. (NASAA)[1] appreciates the opportunity to comment on proposed Rule 146(c), which would define a "qualified purchaser" to mean any "accredited investor" as that term is defined in Rule 501 of Regulation D. NASAA is deeply concerned that this proposal sets the threshold for state preemption too low, particularly as to the "natural person" tests found in Rule 501(a)(5) and (6). NASAA believes that using a 20 year old test, under which many unsophisticated investors are now considered to be "accredited," does not advance Congress' intent that §18(b)(3) of the Securities Act of 1933 preempt only securities which are sold to investors with the financial acumen such that the protections provided by state securities regulation are unnecessary.

NASAA proposes that the Commission adopt the Investment Company Act of 1940 ('40 Act) definition of "qualified purchaser," which provides better investor protection while advancing the intent of Congress.

In the event the Commission is unwilling to adopt the '40 Act definition, NASAA proposes an alternative definition, which does not offer the same degree of investor protection as the '40 Act definition, but is preferable to the accredited investor standard proposed in the Release. Under our alternate proposal, a "qualified purchaser" would be defined as a person with:

1. **$1,000,000 in investments; and**

[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 and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

2. **A net worth of $2,000,000 (exclusive of the investor's primary residence); provided,**

   That the amount of required investments and net worth will be increased annually based on the annual percentage change, if any, in the Consumer Price Index for all urban consumers, as published by the Department of Labor.

These proposals will be discussed in detail below. We will also respond to several additional issues raised by the Release.

Problems with the Current "Accredited Investor" Definition

The current accredited investor definition is flawed because it has never been adjusted for inflation. Furthermore, in calculating net worth, the definition includes all assets without qualification as to liquidity and begs the question of whether possession of such assets is an indicator of financial sophistication.

Inflationary Impact

Rule 501 of Regulation D defines an "accredited investor" to include a person with net worth of $1,000,000 or income of $200,000 ($300,000 jointly).[2] NASAA believes that the current "accredited investor" definition is inadequate protection for investors because it has not been adjusted for inflation in 20 years. This concern was shared by the Task Force on the Future of Shared State and Federal Securities Regulation (Task Force),[3] which consisted of persons with academic, industry, legal, and regulatory expertise and included, among others, a then current SEC commissioner, a former chairman of the Commission, several former high-ranking SEC officials, and a former Attorney General of the United States. The Task Force concluded that "qualified purchaser" should not be defined at the accredited investor level, as the "accredited investor" definition was too low.[4]

The concept of an "accredited investor" as a substitute for financial sophistication originally appeared in the '33 Act in 1980 with the promulgation of Rule 242.[5] The

[2] Securities Act of 1933, Rule 501(a)(5) & (6).
[3] The North American Securities Administrators Association (NASAA) convened the Task Force on the Future of Shared State and Federal Securities Regulation (Task Force) in October 1995 "to recommend ways in which more efficient and effective combined state and federal regulation can be provided to the U.S. securities markets without sacrificing investor protection or eroding investor confidence in the marketplace." See Report of the Task Force on the Future of Shared State and Federal Securities Regulation (1997) ("Task Force Report").
[4] Task Force Report at 60.
[5] See Release No. 33-6180 (January 17, 1980).

definition was revised in 1982 to include the net worth and income tests in what are now found in Rule 501(a)(5) and (6).[6] These tests remain the same as when adopted in 1982. Had these standards been adjusted for inflation, the $1,000,000 net worth test of 501(a)(5) would now require a minimum net worth of approximately $1,830,000.[7] The $200,000 income test of Rule 501(a)(6) would now be approximately $366,000, while the $300,000 joint income test would be adjusted to approximately $549,000.[8]

Both Congress and the Commission have previously recognized the erosive impact of inflation on monetary thresholds. The Securities Markets Enhancement Act of 2000 Congress would have increased the Commission's aggregate offering amount cap for rulemaking under §3(b) of the '33 Act from $5,000,000 to $10,000,000, subject to subsequent annual adjustments for inflation.[9] As discussed further below, in 1998 the Commission made inflationary adjustments to the "qualified client" definition found in Rule 205-3 of the Investment Advisers Act of 1940.[10]

Net Worth Test is Flawed

The current net worth standard in the accredited investor definition includes all assets without limitation, yet houses, furnishings, automobiles, and other "lifestyle" assets are not an indication of financial sophistication, nor can they be easily liquidated in the event the owner needs to generate cash. Similarly, as demonstrated by the well publicized problems faced by employees of Enron, Polaroid and other companies, retirement accounts are not necessarily a reliable indicator of financial sophistication as witnessed by the fact that many such accounts were not diversified, leaving investors vulnerable when the companies collapsed.

Many investors meet the proposed net worth test based on equity in their homes combined with years of regular contributions to retirement and deferred compensation plans, yet neither home ownership, nor investment experience that is limited to retirement or deferred compensation plans with few investment options, demonstrates financial sophistication.

According to the U.S. Census Bureau, home ownership accounts for approximately 44% of all wealth.[11] Furthermore:

> Net worth rises with age, peaks at age 65 to 69, and then begins to decline.

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[6] See Release No. 33-6389 (March 8, 1982).
[7] Based on Consumer Price Index – All Urban Consumers (CPI-U), U.S. Department of Labor-Bureau of Labor Statistics.
[8] *Ibid.*
[9] Securities Markets Enhancement Act of 2000, S. 2107, 106th Cong. §311 (1999).
[10] Investment Advisers Act Release No. 1731, §II.B.1 (July 15, 1998)
[11] U.S. Census Bureau, Survey of Income and Program Participation, 1995.

> Up to a point, increasing age represents more time to accumulate wealth…. Median net worth was 15 times higher for households with householders aged 65 to 69 than for those with householders under 35 years old. The net worth of householders aged 75 and over was about 11 times that of householders under 35 years old.[12]

Defining "qualified purchaser" at the level of the present accredited investor test would undermine the registration process and will seriously compromise investor protection, particularly as it pertains to one of our most vulnerable populations, senior citizens.

Accredited Investors have been victimized by fraud.

Increasingly, state enforcement cases are finding "accredited investors" who have been victimized by securities fraud. The following are examples of unsophisticated accredited investors who were victims in recent cases investigated by state securities agencies:

- Two unmarried sisters in their mid-nineties invested almost all of their assets with a non-NASD member broker who put the proceeds into debentures for her own business. The money they invested is now gone.
- A seventy-year-old widow invested $170,000 in a pay phone lease-back program through an unregistered broker.
- An insurance agent convinced an eighty-five year-old widow that her CD's were poor investments. She invested $144,000 in a pay phone lease-back program and intended on investing more. The promised returns have not materialized.
- A 67 year-old invested $200,000 in a promissory note she bought through her minister who was not registered to sell securities. The notes are several years past due, but the investor still trusts the seller and hopes she will get her money back.
- In a Maryland case, seven accredited investors invested several hundred thousand dollars in fraudulent Ponzi schemes offered by a registered representative.

Another example of unsophisticated accredited investors can be found in a case that the SEC is currently litigating. The SEC recently brought an action in federal district court in Seattle alleging that Znetix/Health Maintenance Centers had defrauded investors of approximately $90 million dollars. Many of the victims were accredited investors.

[12] *Ibid.*

Preemption will subject investors to increased risk of fraud.

States frequently use violations of their registration provisions as the basis for stopping fraud. A state regulator can issue a cease and desist order or obtain a preliminary injunction by simply proving the existence of a security and the absence of an effective registration statement. Were the states, because of preemption, unable to use this tool, they would have to devote substantial time and effort to prove fraud, which prolongs the public's exposure to harm and further taxes limited state resources.

Adoption of the definition contained in the Release would be a boon to promoters of investment scams, as they would claim that all their investment programs are being offered solely to "qualified purchasers." State regulators would be helpless to protect their citizens from these frauds because the federal government will have preempted the registration provisions of state law. All regulators know examples of prime bank schemes, promissory notes, pay telephones, automated teller machines and viatical settlement contracts in which investors recently have lost hundreds of millions of dollars. We fear that these cases will mushroom if state registration requirements are preempted for such a low level of qualified purchaser.

While the Commission would have the power to take action based on compliance with its own rules, we question whether the Commission has the resources necessary to review these offerings even if they are filed with the SEC. In this regard, we understand that the Commission does not review Regulation D offerings and that the Commission does not have the resources to bring enforcement actions for local cases.

NASAA's Proposal

Congress has directed that the definition of "qualified purchaser" be determined based upon the public interest, the protection of investors, and the financial sophistication of investors. [13] The accredited investor definition, as well as the other alternative definitions considered by the Commission, attempt to measure financial sophistication in terms of income, net worth, or some other monetary threshold. This methodology is weak because the correlation between wealth and financial sophistication is inexact. The best way to measure financial sophistication would be to interview each potential investor and engage in a detailed examination of the investor's financial and investing knowledge and experience. Such a process, however, would be time consuming and would not result in the type of objective test that is typically favored by the securities industry.

Therefore, NASAA believes that if monetary thresholds are to be used to determine qualified purchaser status, they should be sufficiently high so that the only investors

[13] S. Rep. No. 293, 104th Cong. 2d Sess. at 15 (1996) ("Senate Report") and H. R. Rep. No. 622, 104th Cong. 2d Sess. at 31 (1996) ("House Report"). These committee reports relate to bills that were eventually enacted as NSMIA.

reached by the definition are those more likely to be financially sophisticated and capable of assuming risk.

The Task Force recommended that, for purposes of the '33 Act, "qualified purchaser" should be defined in the same manner as that term is defined under the Investment Company Act of 1940 ('40 Act). NSMIA amended the '40 Act to exclude from the definition of "investment company" those issuers whose outstanding securities are owned exclusively by "qualified purchasers."[14] A person is a "qualified purchaser" if the person owns a certain dollar amount of investments. Congress set the levels at $5 million for individuals and $25 million for institutions and other entities.[15]

NASAA, like the Task Force, believes that the '40 Act definition is the most appropriate definition of "qualified purchaser" as it sets the threshold sufficiently high so that there is a reasonable probability that the investors included in the definition would be financially sophisticated and capable of assuming risk.

NASAA's Alternate Proposal

In the Release, the Commission states that the legislative intent behind §18(b)(3) includes "meaningful preemption" of state securities regulation. NASAA believes that the preeminent goal set forth by Congress in its entire securities regulatory scheme, is the protection of investors, not preemption. Because we believe that the Commission's proposal falls well short of providing meaningful investor protection and the Commission is reluctant to adopt the 1940 Act definition in this context, NASAA has developed an alternate proposal which clearly is not our preferred version but is a substantial improvement on the definition contained in the Release.

In searching for a definition of "qualified purchaser," NASAA examined the federal securities laws searching for other provisions that establish a threshold above which a person could be deemed to be financially sophisticated and capable of assuming risk.

Rule 205-3 of the Investment Advisers Act of 1940 (Advisers Act) provides an exemption from the performance fee prohibitions of Section 205 of the Advisers Act so long as a client that is subject to a performance fee contract is a "qualified client." Under Rule 205-3(d)(1) of the Advisers Act, a "qualified client" includes: (1) a client with at least $750,000 under management with the adviser or more than $1,500,000 of net worth; (2) a client who is a "qualified purchaser" under section 2(a)(51)(A) of the Investment Company Act of 1940; and (3) certain knowledgeable employees of the investment adviser.

[14] Section 3(c)(7), Investment Company Act of 1940.
[15] Section 2(a)(51)(A), Investment Company Act of 1940.

Rule 205-3 was originally adopted in 1985 pursuant to section 206A of the Advisers Act and reflected the Commission's belief that clients who satisfy certain criteria do not need the full protections provided by the Advisers Act's restrictions on performance fee arrangements.[16] In 1996, NSMIA created new section 205(e), which provides that the Commission may determine that certain persons do not need the protections provided by the performance fee prohibitions of section 205. This determination is to be based on such factors as "financial sophistication, net worth, knowledge of and experience in financial matters, amounts of assets under management, relationship with a registered investment adviser and such other factors as the Commission determines are consistent with [section 205]."[17] Rule 205-3 was amended in 1998 to its present form.[18] Among the changes made were inflationary adjustments to both the "under management" test (from $500,000 to $750,000) and the net worth standard (from $1,000,000 to $1,500,000).

NASAA believes that the "qualified client" definition, while not as strong in terms of investor protection as the Investment Company Act definition, can be a basis for creating a definition of "qualified purchaser." We note that both terms have roots in NSMIA and are premised upon a belief that certain financially sophisticated investors do not need certain protections provided by the securities laws. Under this alternative proposal, a natural person would be a "qualified purchaser" for purposes of section 18(b)(3) of the '33 Act if the person has:

1. $1,000,000 in investments; and
2. A net worth of $2,000,000 (exclusive of the investor's primary residence); provided,

> That the amount of required investments and net worth will be increased annually based on the annual percentage change, if any, in the Consumer Price Index for all urban consumers, as published by the Department of Labor.

"Investments" should be defined in the same fashion as that term is defined for purposes of the "qualified purchaser" definition in the Investment Company Act. "Net worth" should be determined in the same way as it is for purposes of Rule 501(a)(5) of the '33 Act, except that the value of the investor's primary residence would be excluded. As discussed above, home ownership accounts for a significant portion of the typical investor's net worth, but is not an indication of financial sophistication. Therefore, by excluding an investor's primary residence from the net worth calculation, this proposal helps assure that qualified purchaser status is based on the investor's financial assets, which are more likely related to the person's financial knowledge, sophistication and ability to absorb risk.

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[16] See Investment Advisers Act Release No. 996 (November 14, 1985)
[17] Section 205(e), Investment Advisers Act of 1940.
[18] Investment Advisers Act Release No. 1731, §II.B.1 (July 15, 1998)

For purposes of defining "qualified purchaser," we have raised slightly the thresholds established in the "qualified client" definition and proposed a conjunctive, instead of a disjunctive, test. We believe that the thresholds for preempting a person from the protection afforded by the registration provisions of his or her state's securities act should be higher than those for allowing a person to enter into a performance fee agreement with the person's investment adviser. In this connection, we note that even though a client may be "qualified" under the Advisers Act, that client still has a fiduciary relationship with an investment adviser who can assist the client in making investment decisions. A "qualified purchaser," on the other hand, will be completely preempted from the protections of state securities registration, regardless of whether that person has the benefit of professional financial advice.

To be a "qualified purchaser" under this proposal, an investor must have a net worth of $2 million, of which at least $1,000,000 must be in "investments" as that term is defined in the Investment Company Act of 1940. [19] The net worth component, which excludes the value of the person's primary residence, gives the investor the ability to absorb some risk, while the investment component is a measure of investor sophistication.

NASAA strongly believes that the definition should include a provision for regular adjustments to accommodate inflationary impacts so that the type of detrimental erosion that we have seen with respect to the current accredited investor definition is not repeated. The language we have proposed for inflationary adjustments is the same as that proposed by Congress in the Securities Markets Enhancement Act of 2000.

Impact on the States

By defining "qualified purchaser" at the accredited investor level, the Commission would adversely impact state regulation of small, local securities offerings. The Commission has requested comment on these impacts. While, as discussed above, NASAA strongly opposes the proposed definition, we have briefly addressed some of these issues below.

Model Accredited Investor Exemption (MAIE)

The Release requests comments concerning the impact the proposal would have on the MAIE. By deeming every accredited investor to be a qualified purchaser, the MAIE provisions adopted by the states will be moot. In discussing the MAIE, the Release states "coordination of the qualified purchaser definition with accredited investor…would work to enforce uniformity here by eliminating variations in state provisions."[20] NASAA finds this comment puzzling, as it would appear that a great deal of uniformity already exists in this area.

[19] Rule 2a51-1(b), Investment Company Act of 1940.
[20] Release 33-8041 at 8.

It is useful to look at the current state of uniformity. With regard to private offerings to accredited investors, uniformity was fully realized with the passage of §18(b)(4)(D), which preempted substantive state regulation of Rule 506 offerings. Following preemption, Rule 506 filings increased dramatically. Defining "qualified purchaser" at the accredited investor level will do nothing to further uniformity with regard to private offerings.

The MAIE addresses public offerings to accredited investors. According to the Release, 40 states have adopted the MAIE or have some other provision that exempts accredited investor transactions. The MAIE has not, however, been widely utilized. This leads to the conclusion that, despite a high degree of uniformity among the states, there are other impediments that hinder the effectiveness of the MAIE. In analyzing this issue, one should first recall the history behind the MAIE.

The MAIE was developed by NASAA in response to California's 25102(n) Qualified Purchaser Exemption and the Commission's corresponding Rule 1001. In the June 1995 proposing release for Rule 1001, the Commission proposed to provide a similar exemption for any state adopting a transactional exemption incorporating the same standards as 25102(n). In the adopting release (33-7285), the Commission stated:

> The Commission reiterates its desire to cooperate with the states and repeats its position that it will create an exemption for any state that adopts an exemption incorporating the same standards used by California. Separate consideration for a federal exemption will be given to states that adopt other similar exemptions that protect the public interest.

In response, the states, through NASAA, adopted the Model Accredited Investor Exemption in April 1997. The Commission, despite the above statement, has never adopted a corresponding federal exemption. For issuers looking to rely on the MAIE at the state level, the only currently available federal exemptions are Rule 504 of Regulation D, Regulation A, or the intrastate offering exemption.

Other than Rule 504, which is limited to $1,000,000 and would also be impacted by this proposal, there is no generally available federal exemption allowing public solicitation of accredited investors. Without such an exemption, this proposal will do little to increase the ability of issuers to make public offerings limited to accredited investors. As further discussed below in connection with Rule 504, we believe small issuers would be better served by adopting a federal exemption in the spirit of Rule 1001 that would make public solicitation of accredited investors more available.

Rule 504

The Commission expresses concern regarding the impact of this proposal on the accredited investor prong of Rule 504, under which issuers may utilize Rule 504 and state accredited investor exemptions, such as the MAIE, to publicly solicit accredited investors. As the Release states, the proposed rule would nullify state accredited investor exemptions, rendering the accredited investor prong of Rule 504 unusable. While NASAA strongly opposes qualified purchaser preemption at the accredited investor level, we believe one of the ideas put forth in the Release has merit: creation of a federal accredited investor exemption that substantially replicates the current MAIE.

As discussed above, the proposed preemption would not facilitate public accredited investor offerings by small issuers because, while there is a great deal of uniformity among the states in this area, federal exemptions are limited. A federal exemption predicated upon compliance with state accredited investor exemptions not only would provide needed uniformity but also would provide important investor protections currently not available at the federal level such as making the exemption unavailable for (1) issuers or affiliates of issuers that are subject to certain current enforcement proceedings or have incurred significant disciplinary history in the offer or sale of securities;[21] (2) issuers which are blank check companies as defined in SEC Rule 419;[22] (3) issuers that employ cold calling tactics unless they know the person being called is an accredited investor; or (4) issuers which fail to disclose that sales can be made only to accredited investors. With enactment in NSMIA of general exemptive authority in Section 28 of the 1933 Act,[23] NASAA believes the SEC has full statutory authority to adopt such an exemption and urges it to do so.

In addition to improving uniformity and facilitating public offerings to accredited investors, an exemption is preferable because it would preserve state regulation of Rule 504 offerings, which are, in many instances, local or regional in scope. In addition, issuers relying on Rule 504 are frequently unsophisticated and are frequently not represented by experienced securities counsel. The states frequently receive questions or complaints concerning these offerings.

Finally, we note that the Commission has previously recognized that the states should be the primary regulators of Rule 504 offerings:

> In enacting Rule 504, the Commission tacitly deferred primary regulatory responsibility to state securities administrators because the size and local

[21] Disqualification provisions currently apply only to offerings made in reliance on Rule 505, 17 CFR §230.505(b)(2)(iii), and they generally do not include violations of state law.
[22] 17 CFR §230.419(a)(2). Blank check companies are not permitted to rely on Rule 504, 17 CFR §230.504(a)(3).
[23] 15 U.S.C. §77z-3.

> nature of these small offerings did not appear to warrant the imposition of extensive federal regulation.[24]

Intrastate Offerings

The Release requests comment on the impact the proposal on the states' ability to regulate intrastate offerings. Should the proposed rule be adopted, any offering that is limited to accredited investors, and satisfies §3(a)(11) of the '33 Act, would not be regulated by the states or the SEC. In this regard, proposed Rule 146(c) would be fundamentally different than other classes of covered securities such as mutual funds and exchange listed securities, which are heavily regulated by the Commission and self-regulatory organizations.

NASAA believes that this is an unwarranted federal intrusion into a totally local offering that should logically be regulated by the state in which the offering is made. We note several other instances in NSMIA where Congress preserved local regulation for local offerings or entities. Specifically, §18(b)(4)(C) excludes from the definition of "covered security" intrastate offerings under §3(a)(11). Under that same NSMIA provision, municipal and other governmental offerings under §3(a)(2) are not preempted as to the state in which the issuer is located. §203A of the Investment Advisers Act preserves state investment adviser registration for financial planners and small portfolio managers. Also, as noted above, private offerings to accredited investors under Rule 506 are already preempted under §18(b)(4)(D) of the '33 Act. As to public offerings, our experience with the MAIE, which is available for intrastate offerings, leads us to believe that there is little demand for intrastate public offerings to accredited investors.

For these reasons, NASAA strongly believes that extending qualified purchaser preemption to intrastate offerings is inappropriate.

Conclusion

NASAA strongly opposes proposed Rule 146(c). Using a twenty-year-old definition as the basis for preemption of state securities regulation endangers investors and does not advance Congress' intent.

State securities registration provides meaningful, important protections to state residents. Unlike most other federally covered securities, preemption for sales to qualified purchasers will apply regardless of issuer size, financial strength, method of offering, or whether the offering has been reviewed by the SEC or a self–regulatory organization. A preemption so sweeping must have a high threshold to insure the likelihood that preemption will only have application to persons truly financially sophisticated and able to absorb risk.

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[24] SEC Release No. 33-7541

For these reasons, NASAA strongly believes that the Investment Company Act definition of qualified purchaser is the most appropriate. Our alternative proposal, requiring both significant net worth and substantial investments, does not advance investor protection to the same degree as the Investment Company Act definition, but it still far preferable to the Commission's proposal.

Sincerely,

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