

Protest to Changes in Accredited Investor Requirements

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Introduction

On December 13, 2006, a rule regarding the requirements to invest with a private investment company was proposed by the United States Securities and Exchange Commission (SEC). This rule was entered into the Federal Register on January 4, 2007 under Part III Securities and Exchange Commission as Rule 509¹.

One effect of the proposed rule would be to raise the monetary requirements to invest in a private investment company. If the proposed rule passes it would now require an investor to have at least 2.5 million dollars in investments versus the current 1 million in net worth or the current annual income requirements².

The SEC's intended purpose of the change according to various sources is for investor protection against fraud, excessive risk, and the investor's inability to comprehend these complicated investment vehicles. The logic behind these rules is that one with greater wealth must be more financially intelligent.

The adverse implications of this change in policy are significant. One unintended side effect is that this change would practically destroy the entrepreneurial nature of the industry. Amit Chokshi, a private investment entrepreneur, says, "As the manager of a small fund, I can attest that seed capital from friends and family is critical, and subjectively raising the accredited investor bar can have profound implications on the

¹United States Securities and Exchange Commission. National Archives and Registration Administration, 2007. Jan, 2007. 1 Feb. 2007 < <http://www.sec.gov/rules/proposed/2006/33-8766fr.pdf>>

²United States Securities and Exchange Commission. National Archives and Registration Administration, 2007. Jan, 2007. 1 Feb. 2007 < <http://www.sec.gov/rules/proposed/2006/33-8766fr.pdf>>

ability of start up funds to survive³.” Another implication is that it would leave many hedge fund-investing upper-middle class Americans without their current funds. As a result “the new rule will just result in more money funneled to the largest investment firms which will further reduce returns⁴.”

Arguments

In formal petition of proposed Rule 509, several arguments have been formulated. The arguments against the new rules focus on economic, logical, and legal problems of the proposal.

Economic

One fundamental problem with the proposed change is that it is not economically supportive to the primary goal of the proposal—to benefit the investor. Due to the fact that existing small funds may go out of business and it will be nearly impossible for new companies to develop, there will be a great decrease in competition. The basic economic understanding of competition conveys that “the more competition there is, the more likely are firms to be efficient and prices to be low⁵.” Therefore, surviving funds will

³ Chokshi, Amit. “SEC Looks to Revise Accredited Investor Rule”. Seeking Alpha. 13 Dec. 2006. 13 Dec. 2006. < <http://seekingalpha.com/article/22311>>

⁴ Chokshi, Amit. “SEC Looks to Revise Accredited Investor Rule”. Seeking Alpha. 13 Dec. 2006. 13 Dec. 2006. < <http://seekingalpha.com/article/22311>>

⁵ “Economics A-Z.” The Economist. 3 Feb, 2007. < <http://www.economist.com/research/Economics/alphabetic.cfm?LETTER=C#competition>>

have less incentive to perform, and keep their already exorbitant fees from rising. This would be in direct conflict with benefiting the investor.

Logical

Another argument focuses around the logical flaws in the newly proposed rules. Wealth does not in fact guarantee financial intelligence as the proposed rule wants to infer. Common examples of this would be people that acquired significant wealth, strictly from professions such as doctors, lawyers, dentists, etc. Others could have become very wealthy through inheritance, professional athletics, upper-level management positions or many other possibilities. Though some of these people could be considered financially intelligent, it is not required for their profession. To think that all of these people mentioned are financially intelligent would be a hasty assumption.

Legal

A legal problem occurs within this proposal as well. These legal issues come from one primary source. The problem is that lack of evidence for this rule would make the entire proposal Arbitrary and Capricious. There has been no significant evidence shown by the SEC that there is a direct relationship between wealth and financial intelligence. Therefore, it is possible that not only this proposal is Arbitrary and Capricious, but the original accredited investor rule is as well.

Alternative Proposal

Due to the protest of this proposed rule it would only be reasonable to come up with an alternative proposal. The goal of the alternative proposal is to highlight the intended effects of the rule and diminish the harmful ulterior implications. The ideal proposal would please most people by defending the investor from fraud and excessive risk, while companies maintain their right to invest without restrictions. Parts of a proposal that would accomplish this goal would include licensing, the implementation of the Sarbanes-Oxley Act, and applied economic principle.

Licensing

Licensing plays a key role in this solution. It helps protect the investor from fraud as well as insures that the manager is well educated in investments. Proper licensing would include the required Series 63 and Series 65 Exams. Passing the Series 63 Exam would confirm that the manager has proper ethical standards necessary to participate in this industry. Passing the Series 65 Exam would confirm that the manager has the proper knowledge to participate in this industry.

Sarbanes-Oxley Act

Another function of this proposal would be the implementation of the Sarbanes-Oxley Act for all owners, managers, and advisors. This would protect the investor from fraud as well as excessive risk. It would do this by making all officers of these companies liable for mishaps in these areas. In the case of Amaranth's 9 billion dollar

collapse, Brian Hunter might not have made such a risky decision on natural gas futures if he had been liable for his decision, and the manipulation of numbers afterwards.

Applied Economic Principle

A very important part of the alternative proposal is the application of economic principle. To benefit the investor one has to drastically increase competition among the industry. This will benefit the investor by decreasing company fees, weeding out companies that aren't on the "up and up" and inhibiting fraud. All of these benefits are natural products of competition. Because of this it is imperative not to raise the financial requirements to invest with these companies. In fact it would be correct to lower or eliminate these requirements.

Effectiveness of Alternative Proposal

The effectiveness of the alternative proposal could be decided when comparing its functions to its original goal. The goal for the alternative proposal is to protect investors from fraud and excessive risk, while companies maintain their right to invest without restrictions.

All fraud is caused by one or more of these three things; Incentive/Pressure (Motivation for Fraud), Rationalization (Ethics, values, character deficiencies), and Opportunity (Circumstances enabling fraud)⁶. The Rule 509 only partially combats one of

⁶ Bagranoff, Simkin, Strand. Core Concepts of Accounting Information Systems. 9th Ed. p. 448 – 451. Copyright 2005.

these three components. It partially prevents the opportunity portion of fraud by making it more difficult to find initial clients.

The alternative proposal, however, eliminates two portions of fraud, as well as partially preventing the third. It completely eliminates the Opportunity for fraud with the implementation of licensing and applied economics. With this in mind, anyone with the intention of fraud would not be allowed to enter the industry because of lack of knowledge to pass the Series 65 Exam. If someone with the intentions of fraud could get the proper licensing, the economic principle of increased competition would weed them out of the industry before they had a chance to do significant harm. The alternative proposal also completely eliminates the Incentive/Pressure portion of fraud because if one could pass the exams and stay in business in a competitive market then there is no longer motivation for fraud because one could make as much money, if not more legally through that business. The alternative proposal could partially prevent the Rationalization portion of fraud also. It would do this by the licensing requirements of a Series 63 Exam. This would check the ethical foundation of any participant.

Excessive risk would decrease because of the implementation of the Sarbanes-Oxley act on owners, manager, and advisors. This would decrease excessive risk because of the liability issues imposed with this act.

Another goal that the alternative proposal would achieve is the ability for companies to maintain investing with no restrictions. None of the solutions implicate any exterior restrictions on how to invest. What they do, however, is force the companies to decide whether current strategies and ethics are worth the liability.

Conclusion

In conclusion, the adoption of Rule 509 is a critical issue for private investment companies, investors, and any other potential participants. Fraud and excessive risk are two malicious issues in this industry that need to be faced. At the same time, it is imperative to look at potential problems with this proposal as well as other alternative solutions.

Our country has the greatest economy in the world because of capitalism and the entrepreneurial spirit. This proposed rule is an insult to both of those ideas. On January 31, 2007, President Bush spoke on the need for less regulation to promote financial markets⁷. Please listen to this and the American spirit, and help keep this proposed rule from passing.

⁷ “Bush Urges Congress to Ease Wall Street Regulation.” Hispanic Business. 1 Feb 2007. <<http://www.hispanicbusiness.com/news/newsbyid.asp?id=54501&cat=Business+News&more=%2Fnews%2Fmore-business-news.asp>>

