# Rebalancing Private Placement Regulation

William K. Siostrom, Jr.\*

## I. INTRODUCTION

Regulating securities offerings entails balancing investor protection and capital formation.<sup>1</sup> Inevitably, this balance gets upset. As financial markets evolve, Congress passes new legislation, the Securities and Exchange Commission (SEC) adopts new rules, and the courts issue unanticipated opinions. These events upset the balance because they happen in an uncoordinated and haphazard manner and oftentimes produce unintended consequences.

Capital formation under the Securities Act of 1933<sup>2</sup> (Securities Act) occurs through private placements and public offerings, each of which is subject to a somewhat distinct securities regulatory regime. This Article focuses on the balance between investor protection and capital formation with respect to private placements. Specifically, I detail various rule changes that were implemented over the years to enhance capital formation. I also discuss other events that have occurred over the same timeframe and have weakened investor protection. Based on more than a decade of following, researching, and writing about private placement regulation, I fear that the latest round of capital formation enhancements has tilted the balance too far in favor of capital formation and away from investor protection, especially given the size of the private placement market today. The purpose of this Article is to draw attention to this potential imbalance so that it can be further studied and debated. Additionally, this Article puts forth a proposal for strengthening private place-

<sup>\*</sup> Professor of Law, University of Arizona James E. Rogers College of Law. I would like to thank participants at "Berle IV" for their helpful comments concerning this Article.

<sup>1.</sup> See David S. Ruder, Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case, 26 PACE L. REV. 39, 43 (2005); see also The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 30, 2012) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

<sup>2.</sup> Securities Act of 1933, Pub. L. No. 73-38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a-aa).

ment investor protection. The proposal is meant to serve as a starting point for debate if policymakers conclude rebalancing is needed.

The Article proceeds as follows. To set the stage, Part II provides background on the Securities Act and describes the differences between public offerings and private placements. Part III explains why rebalancing private placement regulation may be warranted. Part IV offers proposed statutory language for a new civil liability provision in the Securities Act specifically for private placements. Part V concludes.

#### II. THE SECURITIES ACT

Congress enacted the Securities Act in the wake of the stock market crash of 1929.<sup>3</sup> The Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." The Securities Act contemplates two types of offerings—public and private.

#### A. Public Offerings

Generally, a public offering is an offering of securities marketed to the public. Most public offerings must be registered with the SEC.<sup>5</sup> A company—or more precisely, the "issuer"—registers an offering by filing a registration statement. Pursuant to SEC regulations, a registration statement must set forth, or incorporate by reference, various disclosures about the issuer and the offering. These disclosures include audited financial statements, comparative selected financial information, and a detailed description of the issuer's business, properties, intended use of offering proceeds, transactions with management, legal proceedings, and executive compensation.<sup>6</sup> If the registration statement is for an issuer's initial public offering (IPO), the SEC carefully reviews and comments on it; however, the SEC may or may not review one for a non-IPO.<sup>7</sup> Regardless, with limited exceptions, no public offering may proceed until the SEC declares the underlying registration statement effective.

<sup>3.</sup> See James D. Cox, Robert W. Hillman & Donald C. Langevoort, Securities Regulation Cases and Materials 3 (6th ed. 2009).

<sup>4.</sup> Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (citing H.R. REP. No. 73-85, at 1-5 (1933)).

<sup>5.</sup> See 15 U.S.C. § 77e (2012).

<sup>6.</sup> See id.; 1 Harold S. Bloomenthal & Samuel Wolff, Securities Law Handbook §§ 6:21, 6:23 (2012).

<sup>7.</sup> See Abba David Poliakoff, SEC Review: Comfort or Illusion?, 17 U. BALT. L. REV. 40, 43–45 (1987).

As part of the offering process, the issuer must make available to the public the prospectus for the offering. A prospectus is a subpart of a registration statement, and it comprises the bulk of the required disclosures. The policy behind the registration and prospectus requirements is to provide potential investors with a standard package of information about the issuer and offering so that they can make informed investment decisions.

The registration requirement is negatively reinforced by sections 11 and 12(a)(2) of the Securities Act. 11 Under section 11, an investor in a public offering can sue the issuer, its chief executive officer, chief financial officer, directors, and the underwriters of the offering if it turns out that the issuer's registration statement contained a material misstatement or omission. 12 Likewise, under section 12(a)(2), an investor can sue the seller of securities if the prospectus contained a material misstatement or omission. 13 Neither claim requires a plaintiff to prove the defendant acted with a particular state of mind; however, with the exception of the issuer who is strictly liable, a defendant can avoid liability under both sections 11 and 12(a)(2) if he performed a reasonable investigation or due diligence of the issuer and the offering.<sup>14</sup> These civil liability provisions coupled with the due diligence defense are designed to deter erroneous disclosure, filter out marginal offerings, and provide a compensation avenue to wronged investors. They also supplement public enforcement of federal securities laws by enabling plaintiffs to serve as "private attor-

<sup>8.</sup> See 15 U.S.C. § 77e(b) (2012).

<sup>9.</sup> See, e.g., Form S-1, Registration Statement Under the Securities Act of 1933, Part I, 17 C.F.R. § 239.11 (2005) (specifying the contents of a prospectus).

<sup>10.</sup> See SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

<sup>11. 15</sup> U.S.C. §§ 77k, 77l(a)(2) (2000).

<sup>12.</sup> *Id.* § 77k. Technically, the civil liability provisions of the federal securities laws require an untrue statement of a material fact or omission of a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. *See, e.g.*, *id.* §§ 77k(a), 77l(a)(2). The customary practice, which I use in this Article, is to use the much shorter "material misstatement or omission," although it does not have the exact same meaning.

<sup>13.</sup> *Id.* § 77l(a)(2). To determine whether someone is a "seller" for purposes of § 12(a)(2), courts apply the test set forth by the Supreme Court in *Pinter v. Dahl*, 486 U.S. 622 (1988), with respect to identical language under section 12(a)(1) of the Securities Act. In *Pinter*, the Court held that a seller is the "owner who passed title, or other interest in the security, to the buyer for value," or a person "who successfully solicit[ed] the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." 486 U.S. at 642, 647.

<sup>14.</sup> See 15 U.S.C. § 77k(b)(3) (providing for a reasonable investigation defense); id. § 77l(a)(2) (providing for a reasonable care defense).

neys general," an important consideration given the resource constraints of the SEC. 15

Note that section 11 and section 12(a)(2) liability overlaps when a material misstatement or omission appears in the prospectus, which is often the case given that the prospectus contains or incorporates by reference the bulk of the required substantive disclosure. In other words, it is common for a defendant such as an underwriter to get sued under both sections.

Public offerings are undertaken by private companies that want the capital infusion and share liquidity that come with the transition to a public company through an IPO, and by public companies that want to raise additional capital by selling equity or debt securities to the public. Public offerings are typically marketed and sold to the public by a syndicate of underwriters.

#### B. Private Placements

A private placement or offering is an offering of securities made in compliance with an exemption from the registration requirements of the Securities Act that prohibits the issuer from marketing the securities to the general public. Private placements exist because Congress recognized that it did not make sense to require the registration of all securities offerings. Thus, it included a number of registration exemptions in the Securities Act and empowered the SEC to adopt additional exemptions.

Both public and private companies rely on private placement exemptions for a variety of offering types.<sup>19</sup> For public companies, offering types include sales of debt securities to institutional investors and convertible securities to PIPE<sup>20</sup> investors. For private companies, offering types include sales of common stock to angel investors, sales of preferred stock to venture capital funds, and issuances of stock options to employ-

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<sup>15.</sup> Barbara Black, Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance on Deceptive Conduct and the Future of Securities Fraud Class Actions, 36 SEC. REG. L.J. 330 (2008) ("[E]mpirical studies make clear that the SEC cannot investigate and bring enforcement actions against all corporate wrongdoers; the concept of the private plaintiffs acting as a 'private attorney general' as a necessary supplement to the SEC's enforcement powers maintains its vitality." (citations omitted))

<sup>16.</sup> See, e.g., Form S-1, Registration Statement Under the Securities Act of 1933, 17 C.F.R. § 239.11 (2005) (specifying the contents of a registration statement and prospectus).

<sup>17.</sup> See SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953).

<sup>18.</sup> See, e.g., 15 U.S.C. §§ 77c(b), 77d (2012).

<sup>19.</sup> See Jennifer J. Johnson, Private Placements: A Regulatory Black Hole, 35 DEL. J. CORP. L. 151, 173–79 (2010).

<sup>20.</sup> See id. at 174. PIPE is an acronym for *private investment in public equity*. For an overview of PIPE investors, see William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 383 (2007).

ees. 21 Additionally, investment companies such as hedge funds and venture capital funds typically rely on private placement exemptions when selling interests in their funds to investors. 22 Finally, leading up to the recent financial crisis, special-purpose vehicles relied on private placement exemptions to sell billions of dollars of collateralized debt obligations (CDOs), otherwise known as toxic securities. 23

Most private offerings are marketed to investors through an offering document prepared by the issuer and its counsel, typically called a private placement memorandum or PPM.<sup>24</sup> A PPM contains the same sort of disclosure found in a prospectus so that potential investors can make informed investment decisions.<sup>25</sup> A PPM, however, is not filed with or reviewed by the SEC.<sup>26</sup>

Oftentimes, especially in the private-company context, an issuer will hire an investment-banking firm to serve as "placement agent" on the deal.<sup>27</sup> Under this arrangement, the firm markets the offering to investors on behalf of the issuer in exchange for a commission.<sup>28</sup> The placement agent also assists the issuer in preparing the PPM.<sup>29</sup>

Private placement exemptions (or exclusions) include Rule 144A, which limits sales to "qualified institutional buyers"; <sup>30</sup> Rule 701, which limits sales to employees and consultants of an issuer; <sup>31</sup> and Regulation S, which limits sales to non-U.S. buyers or securities markets. <sup>32</sup> By far, the most heavily utilized exemption is Rule 506 of Regulation D, <sup>33</sup> so I describe it here in more detail.

26. Id.

29. Id.

<sup>21.</sup> See William K. Sjostrom, Jr., Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings, 32 Fl.A. St. U. L. Rev. 1, 4–8 (2004).

<sup>22.</sup> See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9354, 77 Fed. Reg. 54,464, 54,472 (proposed Sept. 5, 2012) [hereinafter Eliminating Prohibition].

<sup>23.</sup> See Gerald T. Lins et al., Hedge Funds and Other Private Funds: Regulation and Compliance § 14:18 (2011); see also Fin. Crisis Inquiry Comm'n, the Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 155 (2011), available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

<sup>24.</sup> See 1 Stuart R. Cohn, Securities Counseling for Small & Emerging Companies § 6:20 (2011).

<sup>25.</sup> Id.

<sup>27.</sup> See id. § 6:9.

<sup>28.</sup> *Id*.

<sup>30. 17</sup> C.F.R. § 230.144A (2012).

<sup>31.</sup> Id. § 230.701.

<sup>32.</sup> Id. §§ 230.901-.905.

<sup>33.</sup> See Vlad Ivanov & Scott Bauguess, Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption 3 (Feb. 2012) (memorandum to Craig Lewis, Dir., Div. of Risk, Strategy & Fin. Innovation), http://www.sec.gov/info/smallbus/acsec/acsec1031 11 analysis-reg-d-offering.pdf (noting "that Reg D offerings have been an important if not dominant

To fall within Rule 506, either an offering must be limited to accredited investors and no more than thirty-five unaccredited investors or the issuer must reasonably believe that there are no more than thirty-five unaccredited investors.<sup>34</sup> Rule 501(a) defines "accredited investors" as the following: banks, insurance companies, mutual funds, and certain other specified institutional investors;<sup>35</sup> individuals with net worth in excess of \$1,000,000 (excluding the equity, if any, of the person's primary residence), annual incomes in excess of \$200,000, or joint annual incomes in excess of \$300,000; and executive officers and directors of the issuer.<sup>36</sup> Rule 506 also provides that all unaccredited investors in the offering have to be sophisticated, or the issuer at least has to reasonably believe that they are sophisticated.<sup>37</sup> Securities sold under Rule 506 are "restricted," which means that they generally cannot be resold for at least six months following their issuance.<sup>38</sup>

The policy underlying Rule 506 is that sophisticated investors can fend for themselves and therefore do not need the protections afforded by registration.<sup>39</sup> The rule uses the accredited-investor concept as a proxy for sophistication.<sup>40</sup> Thus, so long as an offering is limited to accredited investors and no more than thirty-five sophisticated, unaccredited investors, the thinking goes that it would be inefficient to require registration.

Notably, investors in a private placement do not have the same recourse for a material misstatement or omission with respect to the offering as investors have in a public offering because neither section 11 nor section 12(a)(2) applies to a private placement. A private placement investor can bring a claim under Rule 10b-5 of the Securities Exchange

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method of capital acquisition since the beginning of 2009"); see also Rutheford B. Campbell, Jr., The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions, 66 Bus. LAW. 919, 926 (2011) (finding that 94% of Regulation D offerings are made under Rule 506).

<sup>34. 17</sup> C.F.R. §§ 230.506(b)(2)(i), 230.501(e) (2012); see also Eliminating Prohibition, supra note 22, at 6.

<sup>35. 17</sup> C.F.R. § 230.501(a)(1) (2012).

<sup>36.</sup> See id. § 230.501(a).

<sup>37.</sup> *Id.* § 230.506(b)(2)(ii). Sophistication in this context means that the investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," either in his own right or with the aid of one or more "purchaser representative(s)." *Id.* For the definition of "purchaser representative," see *id.* § 230.501(h).

<sup>38.</sup> See id. § 230.144(a)(3).

<sup>39.</sup> See id. § 230.506(a). Rule 506 is a section 4(a)(2) safe harbor. In SEC v. Ralston Purina Co., the Court held that section 4(a)(2) (which at the time was labeled as section 4(1)) exempted offerings made to those who can "fend for themselves" and do not need the protection afforded by registration. 346 U.S. 119, 123, 125 (1953).

<sup>40.</sup> See William K. Sjostrom, Jr., Carving a New Path to Equity Capital and Share Liquidity, 50 B.C. L. Rev. 639, 666–68 (2009).

Act of 1934 (Exchange Act),<sup>41</sup> a catchall antifraud provision that applies to all securities transactions.<sup>42</sup> The rule imposes liability on a person who, by use of any means of interstate commerce, makes a material misstatement or omission in connection with the purchase or sale of a security.<sup>43</sup> It does not, however, cast the same specter of liability as sections 11 and 12(a)(2) do. Specifically, in contrast to claims under those sections, a Rule 10b-5 plaintiff must prove, among other things, scienter, reliance, and causation.<sup>44</sup>

#### III. WHY REBALANCING MAY BE WARRANTED

A number of events have occurred over the years that have tilted the private placement regulatory balance away from investor protection and toward capital formation. First, I discuss changes to private placement regulation that enhanced capital formation (some of them arguably also weakened investor protection) and then those that have weakened investor protection. Then, I consider the role of state securities regulation. Finally, I analyze the current state of the private placement market.

### A. Facilitating Private Placement Capital Formation

Notable changes that have facilitated private placement capital formation include the shortening of Rule 144 holding periods, preemption of registration requirements in "blue sky" laws, partial lifting of the ban on general solicitation and advertising for Rule 506 offerings, and raising of the equity-holder trigger of Exchange Act section 12(g)(1).

#### 1. Holding Period Shortening

As mentioned above, securities sold under Rule 506 are "restricted," which means they cannot be resold until a specific holding period has run. <sup>45</sup> The policy behind imposing holding periods is to prevent issuers from circumventing the registration requirement for public offerings by selling securities in a private placement to an individual with the understanding that the individual will immediately resell the securities to the public. <sup>46</sup>

<sup>41. 15</sup> U.S.C. §§ 78a-78pp.

<sup>42. 17</sup> C.F.R. § 240.10b-5 (2012).

<sup>43.</sup> Id. § 240.10b-5(b).

<sup>44.</sup> See 2 BLOOMENTHAL & WOLFF, supra note 6, §§ 27.18, 27.20.

<sup>45.</sup> See supra text accompanying note 38.

<sup>46.</sup> See Notice of Adoption of Rule 144 Relating to the Definition of the Terms "Underwriter" in Sections 4(1) and 2(11) and "Brokers' Transactions" in Section 4(4) of the Securities Act of 1933, Adoption of Form 144, and Rescission of Rules 154 and 155 Under that Act, Securities Act Release No. 5223, 1972 SEC LEXIS 49, at \*18 (Jan. 11, 1972) [hereinafter Notice of Adoption of Rule 144] ("This condition is designed to assure that the registration provisions of the Act are not circumvented

Rule 144 of the Securities Act specifies the holding period.<sup>47</sup> When the SEC originally adopted the rule in 1972, the holding period for restricted securities was two years. After the two years had run, the securities could be sold only if specified information about the company was publicly available and then only through a broker, in limited quantities, and after filing a form with the SEC.<sup>48</sup>

In 1981, the SEC amended Rule 144 to allow a nonaffiliate investor (someone other than a director, officer, or greater than 10% shareholder of the issuer) to sell restricted securities after three years without complying with the manner-of-sale requirement or quantity limitation.<sup>49</sup> Two years later, the SEC amended the rule to drop the information requirement for resales by nonaffiliates who had held the securities for at least three years.<sup>50</sup>

In 1997, the SEC amended Rule 144 to reduce the two- and three-year holding periods to one and two years, respectively.<sup>51</sup> The SEC explained its thinking behind these reductions as follows:

Shorter holding periods should reduce the cost of capital. This particularly should benefit smaller companies, which often sell securities in private placements. A shorter holding period should lower the illiquidity discount given by companies raising capital in private placements . . . . The [SEC] believes that the shorter holding periods will not diminish investor protection, since they are sufficiently long to ensure that resales under Rule 144 will not facilitate indirect public distributions of unregistered securities by issuers or affiliates. <sup>52</sup>

In 2007, the SEC again amended Rule 144 to reduce holding periods.<sup>53</sup> This time, it reconfigured the rule somewhat by imposing a different holding period depending on whether the issuer of the restricted securities was a private or public company. Under the amended rule, which remains in effect today, the holding period is one year for securities issued by a private company and six months for securities issued by a pub-

by persons acting, directly or indirectly, as conduits for an issuer in connection with resales of restricted securities.").

<sup>47.</sup> See 17 C.F.R. § 230.144(d) (2012).

<sup>48.</sup> See Notice of Adoption of Rule 144, supra note 46, at \*1.

<sup>49.</sup> See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6806, 1988 SEC LEXIS 2104, at \*83 (Oct. 25, 1988).

<sup>50.</sup> Id.

<sup>51.</sup> See Revision of Holding Period Requirements in Rule 144 and 145, Securities Act Release No. 7390, 1997 SEC LEXIS 380, at \*1 (Feb. 20, 1997).

<sup>52.</sup> Id. at \*3-\*4.

<sup>53.</sup> See Revisions to Rules 144 and 145, Securities Act Release No. 8869, 2007 SEC LEXIS 2850 (Dec. 6, 2007).

lic company. Once the one year or six months has run, a nonaffiliate investor is free to resell, by any means, any amount of the securities to anyone, including an unsophisticated, unaccredited investor, even if the securities are those of a private company for which there is little or no information publicly available. The SEC again cited increasing the liquidity of privately placed securities and decreasing the cost of capital formation as its primary rationales for the changes.<sup>54</sup> It also declared, without explanation, that these changes do not compromise investor protection.<sup>55</sup>

The SEC's claim regarding the 2007 changes and their effects on investor protection is dubious, but I will assume it is true, at least when considered in isolation. The larger point is that each change over the years incrementally improves the liquidity<sup>56</sup> of privately placed securities, which, in turn, enhances capital formation in two respects. First, as the SEC mentioned, the changes reduce the illiquidity discount required by investors. An illiquidity discount is in part comprised of the amount an investor decreases from what she is willing to pay for an issuer's restricted securities, given that she cannot immediately resell them. Furthermore, prior to 2007, depending on how long she held the securities, the investor would have had to meet other requirements not applicable to unrestricted securities.<sup>57</sup> Thus, shortening the holding period while eliminating the broker, the information requirements, and the quantity limitation, reduces the illiquidity discount required by investors. In other words, issuers will be able to charge higher prices for their securities resulting in them raising more capital. Second, some people may have been unwilling to invest in privately placed securities if they would have been more or less prohibited from freely reselling for three years. As a result, reducing this period from three years to a one-year maximum increases the pool of potential investors, which likely enables issuers to raise more capital through private placements.

### 2. Blue Sky Laws Preemption

Offers and sales of securities are subject to both federal securities laws and state securities laws (known as blue sky laws).<sup>58</sup> Historically, under the blue sky laws of most states, any offering of securities within

<sup>54.</sup> See id. at \*2.

<sup>55.</sup> Id.

<sup>56.</sup> In this context, liquidity refers to the ease with which an investor can sell securities. Holding periods, information and filing requirements, and similar provisions make it harder for an investor to resell. Thus, securities subject to these limitations are considered less liquid.

<sup>57.</sup> The largest component of an illiquidity discount for private-company shares results from the lack of a public market for the shares.

<sup>58. 1</sup> BLOOMENTHAL & WOLFF, supra note 6, § 1:5.

the state's borders either had to be registered with the state or had to fall within an exemption from registration. Thus, to avoid state registration, a private placement had to fall within an exemption under the blue sky laws of each state in which investors were solicited. As a result, conducting a multistate private placement was burdensome for an issuer because state exemptions varied from federal exemptions and from state to state. In response to this burden and other concerns, Congress enacted the National Securities Markets Improvement Act of 1996 (NSMIA), which partially preempted blue sky registration requirements. Included within this preemption are sales of securities in reliance on Rule 506. In other words, following NSMIA's enactment, an issuer no longer had to deal with registering a Rule 506 offering or verifying the availability of an exemption in any state because blue sky registration requirements no longer applied. A stated purpose of NSMIA was "to promote efficiency and capital formation in the financial markets."

#### 3. Ban Lifting

Until 2012, Rule 506 totally prohibited an issuer or anyone acting on its behalf from soliciting investors through general solicitation and advertising—a prohibition the SEC has interpreted broadly.<sup>64</sup> In particular, the SEC commonly considers as general solicitation the solicitation of anyone with whom the company or someone acting on its behalf does not have a pre-existing, substantive relationship.<sup>65</sup> The SEC considers a relationship pre-existing if it is established prior to the solicitation for the particular offering.<sup>66</sup> The SEC considers a relationship substantive if it "would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration."<sup>67</sup> As a result of this interpretation, a company raising capital

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<sup>59.</sup> See Rutheford B. Campbell, Jr., An Open Attack on the Nonsense of Blue Sky Regulation, 10 J. CORP. L. 553, 556 (1985).

<sup>60.</sup> See Therese H. Maynard, The Uniform Limited Offering Exemption: How 'Uniform' is 'Uniform?'—An Evaluation and Critique of the ULOE, 36 EMORY L.J. 357, 360 (1987).

<sup>61</sup>. Pub. L. No 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

<sup>62. 15</sup> U.S.C. § 77r.

<sup>63. 110</sup> Stat. at 3416.

<sup>64.</sup> See Sjostrom, supra note 21, at 12-15.

<sup>65.</sup> See Robert T. Willis, Jr., P.C., SEC No-Action Letter, 1988 SEC No-Act. LEXIS 34, at \*2 (Jan. 18, 1988); see also Eliminating Prohibition, supra note 22, at 13.

<sup>66.</sup> See E.F. Hutton & Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917, at \*2 (Dec. 3, 1985).

<sup>67.</sup> Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2811, at \*2 (Dec. 4, 1985).

through a Rule 506 offering was essentially limited to seeking funds from investors it, or someone working on its behalf, already knew to such an extent that it had knowledge of the person's sophistication and financial circumstances.<sup>68</sup>

Congress directed the SEC to partially lift the ban in the Jumpstart Our Business Startups Act (JOBS Act). <sup>69</sup> Specifically, Title II of the Act requires the SEC to revise Rule 506 to allow general solicitation and advertising in Rule 506 offerings limited to accredited investors. <sup>70</sup> In August of 2012, the SEC proposed an amendment to Rule 506 to that effect. <sup>71</sup> Finalization of the amendment is anticipated this year. With the ban soon to be removed for offerings limited to accredited investors, issuers will be able to reach out to a much larger pool of potential investors, which, again, likely enables them to raise more capital through private placements. <sup>72</sup>

## 4. Trigger Raising

Historically, section 12(g)(1) essentially required a private company to go public once it had over \$10 million in assets and 500 or more shareholders.<sup>73</sup> This 500-shareholder trigger implicitly constrained capital raising for private companies because it effectively limited the total number of equity investors a private company could accept to 499. For most companies, the number was even lower because market norms required them to issue shares to employees, thus reducing the number of slots available for investors.

Title V of the JOBS Act raised the trigger to 2,000 shareholders (so long as at least 1,500 of such shareholders are accredited investors) and excluded from this count employees who received unregistered shares as part of their compensation.<sup>74</sup> The end result is that private companies will be able to take on more investors than before without having to go public, and thus, they will be able to remain private longer than in the past, resulting in more capital being raised through private placements.

<sup>68.</sup> See Sjostrom, supra note 21, at 14.

<sup>69.</sup> Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in various sections of 15 U.S.C.).

<sup>70.</sup> See id. § 201(a)(1).

<sup>71.</sup> See Eliminating Prohibition, supra note 22.

<sup>72.</sup> See id. at 47.

<sup>73.</sup> See William K. Sjostrom, Jr., Questioning the 500 Equity Holders Trigger, 1 HARV. BUS. L. REV. ONLINE 43 (2011).

<sup>74.</sup> Jumpstart Our Business Startups Act § 501.

## B. Weakening Investor Protection

Notable events that have weakened investor protection include the confinement of Securities Act section 12(a)(2) to public offerings, the narrowing of Exchange Act Rule 10b-5, and the SEC's failure to adjust the definition of accredited investor for inflation.

#### 1. Section 12(a)(2) Confinement

As discussed above, section 12(a)(2) applies to material misstatements and omissions from a prospectus.<sup>75</sup> Section 2(a)(10) of the Securities Act defines the term prospectus to include essentially any written communication that offers a security for sale.<sup>76</sup> Thus, for decades most courts and commentators assumed that section 12(a)(2) applied to private placements because PPMs and other written offering materials seemingly fell within the definition of prospectus.<sup>77</sup> Things changed, however, in 1995 when the Supreme Court decided *Gustafson v. Alloyd Co.*<sup>78</sup>

The case involved the petitioners' sale of a manufacturing company to the respondents. The sale was structured as a stock purchase, meaning the petitioners sold 100% of the company's outstanding stock to respondents. The parties consummated the sale pursuant to a stock purchase agreement that contained various representations and warranties about the company. Petitioners did not register their sales of securities with the SEC but instead relied on a private placement exemption for compliance with the Securities Act. Petitioners and warranties are selected in the securities are selec

Following closing of the sale, respondents claimed that representations and warranties in the stock purchase agreement regarding the financial data of the company were inaccurate. 83 Thus, they sued petitioners for rescission under section 12(a)(2) claiming that the stock purchase agreement was a prospectus containing material misstatements. 84

After applying dubious statutory interpretation,<sup>85</sup> the Court concluded that "the word 'prospectus' is a term of art referring to a document that describes a *public offering* of securities by an issuer or control-

<sup>75.</sup> See supra text accompanying note 13.

<sup>76. 15</sup> U.S.C. § 77b(a)(10) (2012).

<sup>77.</sup> See Cox, Hillman & Langevoort, supra note 3, at 521.

<sup>78.</sup> Gustafson v. Alloyd Co., 513 U.S. 561 (1995).

<sup>79.</sup> Id. at 564.

<sup>80.</sup> Id. at 565.

<sup>81.</sup> Id.

<sup>82.</sup> *Id*.

<sup>83.</sup> Id. at 565-66.

<sup>84.</sup> Id.

<sup>85.</sup> See Elliott J. Weiss, Securities Act Section 12(2) After Gustafson v. Alloyd Co.: What Questions Remain?, 50 BUS. LAW. 1209, 1212–13 (1995).

ling shareholder."<sup>86</sup> Because the sale of stock at issue did not involve a public offering, the stock purchase agreement was not a prospectus and therefore section 12(a)(2) did not apply to the transaction.<sup>87</sup> In other words, section 12(a)(2) does not apply to private placements.

An unsettled issue from *Gustafson* is the definition of public offering for purposes of section 12(a)(2). The issue is complicated by the fact that using the distinction between registered and exempt does not work because some types of exempt offerings are marketed to the public.<sup>88</sup> Additionally, the Supreme Court has held in a different context that an offering made to those who cannot "fend for themselves"—namely, unsophisticated investors—is a public offering even if the offering is not made to the public at large. 89 Regardless, it is highly unlikely a court would consider a Rule 506 offering as public given that Rule 506 states that offers and sales of securities made in compliance with the rule "shall be deemed to be transactions not involving any public offering." 90 This language dates back to 1982 when the SEC originally adopted Rule 506. 1 In other words, it was not included in light of *Gustafson*. It is there because Rule 506 is a section 4(a)(2) safe harbor. Specifically, an offering made in compliance with Rule 506 is deemed to fall within section 4(a)(2) of the Securities Act, and exempts from registration "transactions by an issuer not involving any public offering."92

## 2. Rule 10b-5 Narrowing

As mentioned above, Rule 10b-5 of the Exchange Act is a catchall antifraud provision that applies to all securities transactions. It imposes liability on a person who, by use of any means of interstate commerce, makes a material misstatement or omission in connection with the purchase or sale of a security.<sup>93</sup> Following *Gustafson*, it is basically the only

88. For example, offerings made in reliance on the exemption provided by Rule 251 of Regulation A, 17 C.F.R. § 230.251, can be marketed to the public. *See* 1 BLOOMENTHAL & WOLFF, *supra* note 6, § 7.2.

<sup>86.</sup> Gustafson, 513 U.S. at 584 (emphasis added).

<sup>87.</sup> See id.

<sup>89.</sup> See SEC v. Ralston Purina Co., 346 U.S. 119, 123, 125 (1953); supra note 39.

<sup>90.</sup> Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 1982 WL 35662, at \*27 (Mar. 8, 1982).

<sup>91.</sup> See id.

<sup>92. 15</sup> U.S.C.  $\S$  77d(a)(2) (2012). Note that the JOBS Act changed the numbering of the section from 4(2) to 4(a)(2).

<sup>93. 17</sup> C.F.R. § 240.10b-5(b) (2012). Note that section 804 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18, and 28 U.S.C.), extended the statute of limitations for Rule 10b-5 claims from the earlier of one year after the discovery of the facts constituting the violation or three years after the violation, to two years after discovery or five years after the violation.

claim available under federal securities law to a private placement investor. But as a result of repeated narrowing, it is not a great one.

Notably, four Supreme Court decisions and a Congressional act contributed to this narrowing. First, the Supreme Court held in 1976 that a Rule 10b-5 plaintiff has to prove that the defendant acted with scienter in making the material misstatement or omission. 94 Second, in 1991, the Supreme Court essentially shortened the statute of limitations on Rule 10b-5 claims by overruling lower courts' practice of using forum states' statutes of limitations. 95 Third, the Supreme Court held in 1976 that there is no private right of action against a party that aided and abetted a Rule 10b-5 violation. 66 Fourth, Congress passed the Private Securities Litigation Reform Act of 1995, which heightened the pleading standard for a Rule 10b-5 claim by requiring a plaintiff to plead "with particularity facts giving rise to a strong inference [of scienter]."97 Finally, in 2011, the Supreme Court contracted the list of potential defendants when it held that a maker of a statement for purposes of Rule 10b-5 is limited to "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."98

One of the few big developments during the above timeframe that was favorable for plaintiffs bringing Rule 10b-5 claims was the Supreme Court's adoption in 1988 of the fraud-on-the-market presumption of reliance. Under this presumption, a Rule 10b-5 plaintiff does not have to prove it relied on the alleged material misstatement or omission; it only has to prove that the securities at issue trade in an efficient market.

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<sup>94.</sup> Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213–14 (1976). The Court described scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. Lower courts have since uniformly held that recklessness suffices.

<sup>95.</sup> Lampf v. Gilbertson, 501 U.S. 350, 359-63 (1991).

<sup>96.</sup> Cent. Bank of Denver v. First Interstate Bank, 511 U.S. 164, 191-92 (1994).

<sup>97.</sup> Pub. L. 104-67, 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(2)(A)). The Act did not define "strong inference" but the Supreme Court addressed the issue in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, ruling that in order to qualify as "strong," "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." 551 U.S. 308, 309 (2007).

<sup>98.</sup> Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011). The Court added that "[w]ithout control, a person or entity can merely suggest what to say, not 'make' a statement in its own right." *Id*.

<sup>99.</sup> See Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988).

<sup>100.</sup> As the Court explained, the presumption "is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." *Id.* at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)). Hence, material misstatements or omissions will "defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." *Id.* at 241–42. Courts typically apply the five factors set forth in *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989) to determine whether shares of stock trade in an efficient market. These factors are the following: (1) the stock's trading volume; (2) the number of analysts following the issuer; (3) the number of market

This presumption opened the door to Rule 10b-5 class action lawsuits because class certification would no longer be denied due to individual questions of reliance predominating over common questions. The presumption, however, is of no help to a plaintiff bringing a Rule 10b-5 claim against a private company given that a private company's shares by definition do not trade in an efficient market. Nor is it of any help to a plaintiff bringing a Rule 10b-5 claim against a public company relating to, for example, privately placed debt securities that do not trade in an efficient market.

Of the above developments, the most problematic for an investor in a private placement is the heightened pleading standard. In particular, pleading facts giving rise to a strong inference of scienter is difficult because a plaintiff must do so before discovery. Meeting this standard will often be impossible in a suit against a private company because there will be no company or insider SEC filings from which the plaintiff can pull facts for its pleading.

As for the scienter requirement, it may create a perverse incentive for private offering participants to be less thorough in their due diligence. Specifically, courts have held that a defendant who had a "white heart" but "empty head" with respect to a misstatement or omission did not act with scienter. Thus, offering participants may not dig as deeply as they otherwise might so that they can later claim a white heart but empty head.

Note that the Supreme Court and Congress have narrowed Rule 10b-5 largely out of concern that vexatious class actions would be brought against public companies following a sudden drop in their stock prices. <sup>103</sup> Consequently, it does not reflect a deliberate choice as to the proper level of civil liability exposure for a private placement.

#### 3. Failure to Adjust

An individual qualifies as an accredited investor if he or she (1) makes more than \$200,000 a year or, together with his or her spouse, more than \$300,000 a year; or (2) has a net worth in excess of \$1,000,000 (excluding the equity, if any, of the person's primary residence). The SEC set these dollar thresholds when it adopted Regula-

makers for the stock; (4) the eligibility of the issuer to file a Form S-3 registration statement; and (5) the stock price's reaction to unexpected new events. *Id.* at 1286–87.

<sup>101.</sup> See In re Initial Pub. Offerings Secs. Litig., 471 F.3d 24, 43 (2d Cir. 2006).

<sup>102.</sup> See, e.g., Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

<sup>103.</sup> See H.R. Rep. No. 104-50, at 16–20 (1995); see also Cox, HILLMAN & LANGEVOORT, supra note 3, at 663.

<sup>104.</sup> Ironically, the exclusion of home equity from the net worth calculation was added by Congress in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

tion D in 1982, and the SEC has never adjusted them for inflation.<sup>105</sup> Hence, the dollar amounts have dropped significantly in real dollars as the result of inflation. Specifically, \$1.00 in 1982 is worth \$2.40 in 2012.<sup>106</sup> Thus, the \$200,000, \$300,000, and \$1,000,000 thresholds, had they been adjusted for inflation, would today be \$474,000, \$948,000, and \$2,370,000, respectively.<sup>107</sup> In other words, inflation has decreased the thresholds in real dollars by approximately 58% since adoption.

As applied to individuals, the accredited investor concept is based on the assumption that rich people are sophisticated or at least can sustain a complete loss of an investment in a private placement without suffering financial ruin. This assumption was not particularly sound in 1982 but was at least understandable given the desire for an objective proxy for sophistication. The lack of inflation adjustment, however, means that many more individuals qualify as accredited investors than in 1982. As a result, considerably fewer individuals are protected from foolishly investing in private placements.

In 2007, the SEC proposed adjusting the thresholds for inflation "on a going forward basis, starting on July 1, 2012, and every five years thereafter" using 2006 as the base year; 108 however, for reasons unknown, it never adopted the proposal.

#### C. State Law

As mentioned above, offers and sales of securities are subject to both federal and state securities laws. While NSMIA preempted blue sky registration requirements for Rule 506 offerings, it did not preempt the application of blue sky civil liability provisions. Many states have a provision similar to section 12(a)(2) that imposes liability on those who sell securities using, for example, a PPM that contains a material misstatement or omission. <sup>109</sup>

Congress passed the legislation in the wake of the financial crisis that, among other things, drastically reduced everyone's home equity. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 413(a), 124 Stat. 1376, 1577 (2010).

<sup>105.</sup> See Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8825, 72 Fed. Reg. 45,116, 45,126 (proposed Aug. 10, 2007) [hereinafter Revisions of Limited Offering Exemptions].

<sup>106.</sup> See CPI Inflation Calculator, BUREAU OF LABOR STAT., http://data.bls.gov/cgi-bin/cpicalc.pl (last visited Nov. 4, 2012).

<sup>107.</sup> Revisions of Limited Offering Exemptions, supra note 105.

<sup>108.</sup> Id. at 45,126.

<sup>109.</sup> For example, section 509(b) of the Uniform Securities Act of 2002, which seventeen states have enacted, provides as follows:

A person is liable to the purchaser if the person sells a security . . . by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not mis-

The existence of these provisions blunts the impact of Gustafson to some extent. But it is not an investor panacea for several reasons. First, some states only have scienter-based provisions, and New York's provision can be enforced only by its attorney general, 110 notwithstanding all the private placement activity that originates in the state. Second, courts have held that a plaintiff can only sue under a particular state's blue sky laws if activities with respect to the offering at issue were conducted in the state. 111 Third, a federal court in Ohio recently held that an antifraud cause of action was not available under an Ohio blue sky law for non-Ohio purchasers of securities issued by an Ohio entity. 112 This clouded the extraterritorial application of blue sky antifraud provisions. Fourth, the Securities Litigation Uniform Standards Act of 1998 prohibits certain class actions under state law for misstatements or omissions in connection with the sale of securities. 113 Specifically, an investor in a private placement of common or preferred stock by a public company with shares listed on the New York Stock Exchange or NASDAQ could not bring a class action under a blue sky law, even if the PPM was littered with material misstatements and omissions. 114 As a result, investor recourse under blue sky law is essentially left to chance. Available remedies vary by state, depend on where offering activities occurred, and may be limited to state residents.

A plaintiff could potentially bring claims under state common law or equitable claims such as rescission, deceit, and, in some states, equitable fraud. However, a rescission claim generally requires proof of reliance, which likely forecloses bringing the claim as a class action. De-

leading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.

<sup>110.</sup> See Bd. of Managers v. Fairways at N. Hills, 150 A.D.2d 32 (N.Y. App. Div. 1989).

<sup>111.</sup> See Robert N. Rapp, Misapplication of the Federal Extraterritoriality Principle in Limiting the Scope of Civil Remedies for Fraud Under State Blue Sky Laws, 39 SEC. REG. L.J. 279 (2011).

<sup>112.</sup> See In re Nat'l Century Fin. Enters., Inc., Inv. Litig., 755 F. Supp. 2d 857, 888 (S.D. Ohio 2010).

<sup>113.</sup> Pub. L. No. 105-353, 112 Stat. 3227 (codified at various parts of 15 U.S.C. ch. 2b).

<sup>114.</sup> See 15 U.S.C. § 77p(b) (prohibiting class actions with respect to "covered securities"); id. § 77f(1) (defining a "covered security" by referencing subsection (1) and (2) of section 18(b) of the Securities Act); id. § 77r(b)(1)(C) (providing that "covered security" includes "a security of the same issuer that is equal in seniority or that is a senior security to a security" the issuer has listed on the NYSE or NASDAQ); id. § 77r(d)(4) (defining "senior security" to include "any stock of a class having priority over any other class as to distribution of assets or payment of dividends").

<sup>115.</sup> See Richard W. Painter, Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 CORNELL L. REV. 1, 21 (1998).

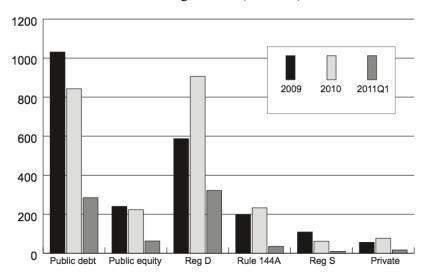
<sup>116.</sup> See 2 Louis Loss, Joel Seligman & Troy Paredes, Fundamentals of Securities Regulation 1553 (2011).

ceit requires proof of scienter, 117 which, as discussed above, is difficult to plead and prove in the private offering context. 118

## D. Analysis

Over the last two decades there have been a number of significant changes to federal securities laws designed to enhance private placement capital formation, and they appear to have worked well. According to a February 2012 SEC report that provided data for 2009, 2010, and the first quarter of 2011, capital raised through Regulation D offerings was (1) more than double the capital raised though public equity offerings during that timeframe; (2) second only to public debt offerings in 2009; and (3) the largest source of capital in 2010 and through the first quarter of 2011. The bar graph below, which is reproduced from the SEC report, reflects these three points. 120

Figure 1: Aggregate Capital Raised in 2009, 2010, and Q1 2011 by Offering Method (\$billions)



Note that the graph breaks down private offerings into four different categories—Regulation D, Rule 144A, Regulation S, and other private offerings—presumably because the report focuses on Regulation D offerings. Hence, depicting aggregate capital raised in private placements

<sup>117.</sup> See id. at 1555.

<sup>118.</sup> See supra Part III.B.2.

<sup>119.</sup> Ivanov & Bauguess, supra note 33.

<sup>120.</sup> Id.

during the specified years would require redoing the graph to stack the bars of each of these four different categories on top of one another. This means that capital raised in private placements exceeded \$1 trillion in 2010 and was on pace to do so for 2011. With the impending partial lifting of the ban on general solicitation and advertising for Rule 506 offerings and the increase in the section 12(g)(1) trigger, the growth of the private placement market is likely to accelerate.

Although private placements have eclipsed public offerings in terms of total dollars raised, virtually nothing has been done in decades to strengthen investor protection in this area. Thus, there is this giant market segment whose growth is likely to accelerate subject to very little regulatory oversight and only a weak liability rule. I fear that this dynamic results in underdeterrence of erroneous disclosure and underencouragement of due diligence for private placements and may give rise to systemic risk concerns. My intuition may be off base, but at a minimum, the SEC should closely monitor the size of the market and investor complaints arising out of private placements. It should also gather more historical data on these two aspects to better inform any policy debate.

#### IV. REBALANCING PROPOSAL

My proposal is meant as a starting point for a stage-two discussion. Stage one would involve fact gathering and debate over whether rebalancing is necessary. If the answer is yes, the discussion would then presumably move to stage two—a debate of what exactly should be done. Thus, my proposal reflects necessarily preliminary thoughts (given that the stage-one discussion has yet to occur) and is meant to serve as a starting point for a stage-two debate.

I generally support all the changes to federal securities laws discussed above that were made to enhance capital formation. In fact, in a 2004 article, I argued that the SEC should relax the ban on general solicitation and advertising, <sup>122</sup> and in an article published last year, I encouraged the SEC to liberalize the section 12(g)(1) trigger. <sup>123</sup> I support the changes largely because private placements are an extremely important

<sup>121.</sup> I am only aware of three instances of strengthening: (1) the SEC amending Rule 504 in 1999 to reverse its earlier decision to allow general solicitation and remove resale restrictions, *see* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 1999 WL 95490, at \*1 (Feb. 25, 1999); (2) Congress changing the definition of accredited investor to exclude home equity from the net worth calculation, *see supra* note 104; and (3) Congress expanding the "bad actor" disqualifier for Rule 506 offerings. I do not count the extension of the Rule 10b-5 statute of limitations noted earlier because it was not aimed at private placement investor protection. *See supra* sources cited at note 93.

<sup>122.</sup> See Sjostrom, supra note 21.

<sup>123.</sup> See Sjostrom, supra note 73.

source of capital for emerging companies, private placements are the growth engines of our economy, and access to capital is critical to their success. Thus, my proposal calls for rebalancing by increasing investor protection. Set forth below is suggested statutory language to that end.

#### A. Suggested Statutory Language

### Sec. 11A. PRIVATE PLACEMENT CIVIL LIABILITIES

- (a) In the event any security is sold (i) in an issuer transaction exempt under section 4(a)(2) or commission rules or regulations issued under section 4(a)(2) or section 3(b), or (ii) under Rule 144A in connection with an issuer transaction, 124 by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition the acquirer knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
  - (1) the issuer;
- (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the transaction;
- (3) every person who was a principal executive officer, principal financial officer, principal accounting officer, or controller of the issuer (and any person occupying a similar status or performing a similar function) at the time of the transaction; and
- (4) every placement agent (as defined by the commission by rule) with respect to the transaction to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if such person no longer owns the security.
- (b) Notwithstanding the provisions of subsection (a), no person, other than the issuer, shall be liable who shall sustain the burden of proof that he has met the due diligence defense as defined by the commission by rule.

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<sup>124.</sup> This language is necessary so that section 11A applies to Rule 144A offerings that involve the sale by an issuer to a placement agent in reliance on section 4(a)(2) or Rule 506 followed by the immediate resale by the placement agent to investors in reliance on Rule 144A.

(c) Subsection (a) shall not apply, except with respect to an issuer, to (i) a transaction that was part of an offering sold only to accredited investors as defined in section 230.501 of title 17, Code of Federal Regulations, provided that the acquirer signed a writing expressly waiving application (notwithstanding section 14), and (ii) a transaction that was part of an offering sold only to qualified institutional buyers as defined in section 230.144A of title 17, Code of Federal Regulations, unless the issuer signed a writing expressly consenting to its application.

As well as adding this suggested language, Congress would need to include a reference to section 11A in section 13 of the Securities Act (statute of limitations) and section 15 of the Securities Act (controlperson liability) so that those sections apply to section 11A claims.

My proposal is modeled after section 11 of the Securities Act (that is why I labeled it "section 11A"). I chose this route as opposed to simply proposing to legislatively reverse *Gustafson*—an approach that has been floated in recent years <sup>125</sup>—for two reasons. First, section 12(a)(2) is really just a supplement to section 11. Its main effect is to extend civil liability to broker-dealers, given that it only applies to "sellers," and the only other sellers in a public offering are the issuer and underwriters, both of whom are subject to section 11 liability. Second, unlike section 11, section 12(a)(2) does not provide strict liability for an issuer. Considering the size of the private placement market, I believe a provision that imposes strict liability on the issuer and primary liability on an issuer's directors, chief executive officer, chief financial officer, and the placement agent for the offering is warranted. <sup>126</sup>

<sup>125.</sup> For example, in 2010, Senator Carl Levin introduced amendments to the Dodd-Frank Act that included a section called the "Gustafson Fix." See S. 3217, 111th Cong. § 212 (2010). The amendment would have changed the definition of prospectus under Securities Act section 2(a)(10) to make clear that it includes any written communication offering a security in a registered or exempt transaction. The amendment was not, however, included in the enacted version of the legislation.

<sup>126.</sup> Congress appears to have tacitly agreed in the JOBS Act that section 12(a)(2) liability, standing alone, is too narrow. Specifically, the "crowdfunding" exemption of the JOBS Act includes a liability provision similar to section 12(a)(2) that is applicable only to an "issuer." See Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315–18 (2012) (codified at 15 U.S.C. § 77d). The provision then defines issuer to include an issuer's directors, chief executive officer, and chief financial officer. Id. I recognize that an issuer's officers and directors are potentially liable for a section 12(a)(2) violation by the issuer under the control-person liability provision of section 15 of the Securities Act. Such a claim, however, is often difficult for a plaintiff to prevail on because courts have required a plaintiff to prove the person (1) "actually participated in (namely, exercised control over) the operations of the [company] in general," and (2) "possessed the power to control the specific transaction or activity upon which the primary violation is predicated." Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985) (quoting Metge v. Baehler, 577 F. Supp. 810, 817–18 (S.D. Iowa 1984)). Additionally, some courts also require a plaintiff to prove that the defendant was an active participant in the violation or that the person's inaction "was deliberate and done intentionally to further the fraud." See, e.g., Sharp v. Coopers & Lybrand, 649 F.2d 175, 185 (3d Cir. 1981).

As with section 11, my proposal affords all defendants, other than the issuer, a due diligence defense. <sup>127</sup> In contrast to section 11, I delegate to the SEC the task of specifying what exactly a particular category of defendants needs to do to meet the defense. 128 The due diligence defense under section 11 has been left largely to the courts. Because of the frequency of pretrial settlements in securities fraud cases, the defense remains somewhat ill-defined with Escott v. BarChris Construction Corp., 129 a 1968 federal district court opinion, still serving as the leading case. 130 Going with SEC rulemaking instead would allow the SEC to gather public input and then specify what exactly various offering participants need to do, tailor the defense to different types of private placements, and periodically update the defense in light of changing market practices or rules. It would also provide potential investors with more certainty as to the extent of due diligence performed in connection with an offering, which they can then take into account in deciding how much they are willing to pay for the offered securities. What I have in mind is something akin to Financial Industry Regulatory Authority (FINRA) Regulatory Notice 10-22, which details various practices a broker-dealer participating in a private placement should undertake in investigating the issuer. 131

Subsection (c) of my proposal provides flexibility as to the applicability of section 11A. Specifically, it allows investors in offerings sold only to accredited investors to waive application except as to the issuer. For offerings limited to qualified institutional buyers (QIBs), <sup>132</sup> it provides a "no application" default rule except with respect to the issuer. Hence, my proposal sets an immutable rule for offerings where unaccredited investors participate, an opt-out rule for offerings limited to accredited investors, and an opt-in rule for offerings limited to QIBs. This approach is grounded in the fundamental principle of U.S. securities laws

<sup>127.</sup> See Pub. L. No. 73-38, § 11(b), 48 Stat. 74 (1933).

<sup>128.</sup> See id.

<sup>129. 283</sup> F. Supp. 643 (S.D.N.Y. 1968).

<sup>130.</sup> See William K. Sjostrom, Jr., The Due Diligence Defense Under Section 11 of the Securities Act of 1933, 44 Brandels L.J. 549, 549 (2006).

<sup>131.</sup> See Fin. Indus. Regulatory Auth., Regulation D Offerings: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, Reg. Notice 10-22 (Apr. 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121 304.pdf. FINRA is the quasi-governmental, self-regulatory organization that oversees all securities firms doing business in the United States.

<sup>132.</sup> Subject to limited exceptions, a QIB is an institutional investor (for example, an employee benefit plan, hedge fund, insurance company, mutual fund, or pension fund) that "acting for its own account or the accounts of other qualified institutional buyers . . . in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity." 17 C.F.R. § 230.144A(a)(1)(i). See generally William K. Sjostrom, Jr., The Birth of Rule 144A Equity Offerings, 56 UCLA L. REV. 409, 424–26 (2008).

that sophisticated investors can "fend for themselves" and therefore require considerably fewer legal safeguards. Thus, my proposal provides the most protection for unaccredited investors (presumably the least sophisticated), less protection for accredited investors (presumably sophisticated 134), and the least protection for QIBs (presumably the most sophisticated 135). Note that an investor who meets the QIB definition also necessarily meets the definition of accredited investor.

More importantly, my proposal allows accredited investors and QIBs to contractually tailor a liability regime for a particular transaction, which leads to greater efficiency. For example, a venture capital investor who has done extensive due diligence on an issuer may prefer that section 11A not apply to an issuer's directors and officers instead of paying the extra money the issuer would presumably demand if it applied. Alternatively, the parties may prefer some other type of liability regime for a particular transaction—a different limitations period, a cap on damages, a different list of potential defendants—than the one provided by section 11A. This sort of tailoring is not currently possible because both the Securities Act and the Exchange Act render advance waivers of claims void 136

Issuers and placement agents are likely to respond to section 11A(c) by including a waiver of the provision as a matter of course in their private placement subscription agreements, the document an investor signs to invest. Even if this is the case, the waiver is applicable only if all investors are accredited and, regardless, does not waive section 11A's application to the issuer. Nor does it waive liability under Rule 10b-5 or control-person liability under section 15. Furthermore, a waiver generally requires a "voluntary or intentional relinquishment of a known

<sup>133.</sup> See SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

<sup>134.</sup> I say "presumed" because the definition of accredited investor uses income and assets as a proxy for sophistication, and thus the definition is both under- and over-inclusive. *See generally* Sjostrom, *supra* note 40, at 666–69.

<sup>135.</sup> See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6806, 53 Fed. Reg. 44,016, 44,028 (Nov. 1, 1988) (defining the QIB as "identifying a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions").

<sup>136.</sup> See 15 U.S.C. § 77n ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." (emphasis added)); id. § 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void." (emphasis added)). This is why I include the "notwithstanding section 14" parenthetical in section 11A(c).

<sup>137.</sup> This assumes that section 15 is amended to so provide.

right." Thus, courts have some flexibility to invalidate a purported waiver.

## B. Some Thoughts on Costs and Benefits

Ramping up liability obviously has its costs. Placement agents will charge issuers higher commissions for offerings to which section 11A applies as compensation for the increased liability risk to them and higher costs of a presumably more in-depth due diligence. At the same time, investors in these offerings should be willing to pay more for the securities knowing that (1) the placement agent performed a certain level of due diligence investigation as specified by SEC rules, and (2) the securities come with an implicit three-year "put right" clause (the right to sue for rescission under section 11A). Other possible costs include those resulting from the filtering out of some good offerings (offerings by companies that appeared marginal to a placement agent but ultimately would have succeeded) because of increased due diligence and increased litigation.

Benefits include stronger deterrence of erroneous disclosure and problematic offerings, and greater incentives for various parties to perform due diligence. These effects should result in the more general benefit of fewer private placements going bad and therefore less money lost by investors. My proposal may also lead to improved investor confidence in the private placement market.

#### V. CONCLUSION

Fundamentally, the federal securities laws are about balancing investor protection and capital formation. When it comes to private placements, however, the balance is currently heavily tilted in favor of capital formation. In my view, this is problematic considering that private placements have eclipsed public offerings in terms of total dollars raised, yet investor protection for private placements is much weaker than for public offerings. Consequently, I have proposed a new civil liability provision to increase private placement investor protection. In an effort to get the balance right, my proposal allows private placement participants to tailor a private placement liability regime for a particular offering. It also enables the SEC to shape the due diligence defense and fine-tune it over time.

I recognize that my proposal is unlikely to gain any traction with Congress in the near term given the current political climate and empha-

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<sup>138.</sup> Royal Air Props., Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964) (citing Matsuo Yoshida v. Liberty Mut. Ins. Co., 240 F.2d 824, 829 (9th Cir. 1957)).

sis on job creation. I did not, however, write this Article to convince Congress to act. My hope is that the Article will spur conversations and further research on whether rebalancing private placement regulation is warranted and, if so, whether my proposal is the best way to do it.