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REVIEW

Sidestepping the Rat Holes: Investment Risk and Securities Law

Thomas M. Selman†

This Article presents a novel understanding of the purpose of federal securities laws as the management of investment risk. Those laws should be treated as a whole. When two rules, even under different statutes, address the same risk, they should be applied concomitantly. For example, broker-dealer regulation under the Securities Exchange Act of 1934 might justify relaxation of prospectus delivery requirements in the Securities Act of 1933.

"The [Securities Act] bill is not foolproof. It will not prevent anybody from putting his money into rat holes . . . ." — Congressman Carl E. Mapes[1]

I. Unsated Curiosity

Mr. Loni Almoni is the ever-punctilious Chief Compliance Officer for Figurative Wealth Management. On October 3, 2016, Almoni reviewed several accounts for Figurative, a registered broker-dealer.[2] Straightening his bowtie,[3] he observed:

- A broker had recommended that customers purchase shares of a registered investment company and shares of an operating company in its initial public offering.
  - Almoni confirmed that the broker had conducted a reasonable inquiry into the securities and his recommendations were suitable.
  - He also confirmed that the prospectus for the registered investment company and the preliminary prospectus for the initial public offering were delivered as required to the customers.

† J.D., Executive Vice President, Regulatory Policy, and Legal Compliance Officer, Financial Industry Regulatory Authority. The views expressed are those of the author and do not reflect the opinions of FINRA or his FINRA colleagues, many of whom would fervently endorse this disclaimer. The author appreciates the provocative commentary of Robert L.D. Colby, Angela C. Goelzer, Alan B. Lawhead, Joseph E. Price, Joseph P. Savage, and Jonathan S. Sokobin.

1 Mapes continued, "but in the exercise of reasonable care he can . . . [find out the facts.]" 77 Cong. Rec. 2,912 (1933).

2 And a figurative company.

3 Almoni also was a fastidious dresser.

- Some of these customers were accredited investors who had purchased private placements without having received private placement memoranda.
  - Upon consultation with the firm's legal staff, Almoni confirmed that delivery of private placement memoranda was not required by law.
- The broker also had recommended a private placement to customers who were not accredited investors.
  - Almoni confirmed that a private placement memorandum had been provided to those customers as required, and that the recommendations were suitable.

Almoni believed that he was an expert in the federal securities laws, but he always brought his questions to the legal department.

- Of what benefit is the private placement memorandum to an unsophisticated customer who purchases through a licensed broker?
- Why must Figurative Wealth Management deliver prospectuses about registered investment companies that are comprehensively regulated to customers who are represented by licensed brokers?
- Why must the firm deliver prospectuses to customers who are qualified to buy privately-placed securities without having received any disclosure?

The legal department could not explain the policy behind these requirements but dutifully cited the applicable rules.

A measure applied in one circumstance, such as prospectus delivery to unsophisticated investors, seems unnecessary in another, such as prospectus delivery to accredited investors. Two conditions with seemingly identical purposes, such as prospectus delivery and investor accreditation, are imposed simultaneously without obvious regard for one another.

This Article proposes a new way to understand the securities laws. In Part II, this Article considers their legislative purpose. For the sake of simplicity, this Article gives particular attention to one set of laws that regulate the formation and sale of securities, the "Product and Sales" Provisions.[4] They are administered by the Securities and Exchange Commission (SEC), the self-regulatory organizations, and the only national securities association, the Financial Industry Regulatory Authority (FINRA).

In Part II, this Article explains that the legislative purpose of the Product and Sales Provisions is investor protection. Investor protection is the confrontation of investment risk. In Part III, Product and Sales Provisions are distinguished as those that prohibit bad conduct like fraud and manipulation from "Prescriptive Provisions" that require certain behavior. In Part IV, this Article

[4] The federal securities laws regulate the creation of some securities products. For example, the Investment Company Act of 1940 regulates the design and operation of investment companies. *See generally* 15 U.S.C. §§ 80a-1–80a-64 (2012). The federal securities laws also regulate the distribution of securities. For example, the Securities Act of 1933 regulates the public distribution of securities. *See generally* 15 U.S.C. §§ 77a–77mm (2012). The Securities Exchange Act of 1934 requires periodic reporting by public issuers and regulates broker-dealers that recommend and sell securities. *See generally* 15 U.S.C. §§ 78a–78pp (2012). The Investment Advisers Act of 1940 regulates investment advisers. *See generally* 15 U.S.C. §§ 80b-1–80b-21 (2012).

For purposes of simplicity, this Article does not include within Product and Sales Provisions the requirements applicable to trust indentures, clearing and transfer agencies, stock exchanges, and alternative trading systems, although these provisions also might be relevant to the manufacture and sale of securities and might advance some of the purposes of the Product and Sales Provisions.

explains how the Prescriptive Provisions confront investment risk, such as the risks related to an issuer's business and the markets in which its securities trade. In Part V, this Article argues for a more cohesive understanding of securities law, framed according to investment risk. The Prescriptive Provisions are viewed as a body of law. By considering together measures under different statutes that address the same type of risk, we produce a coherent understanding of the law. Inefficiencies can be reduced, burdens minimized, and gaps exposed. This Article presents two case studies that demonstrate this.

2. Legislative Purpose of Securities Law

Even a cursory review of the federal securities laws and their legislative history will reveal that protection of investors is their principal purpose. A typical, perhaps formulaic description of the SEC's rulemaking power occurs repeatedly in the federal securities laws: The SEC is to adopt rules that are "necessary or appropriate in the public interest and for the protection of investors."[5] Sometimes the phrase appears in the disjunctive ("in the public interest *or* for the protection of investors") and sometimes in conjunction with other requirements ("in furtherance of this title").[6] Nevertheless, the frequency with which it appears confirms that the SEC's central mission is to protect investors.

Stated most generally, the Securities Act of 1933 (Securities Act) advances investor protection through disclosure, the Securities Exchange Act of 1934 (Securities Exchange Act) and the Investment Advisers Act of 1940 (Investment Advisers Act) through the regulation of financial intermediaries, and the Investment Company Act of 1940 (Investment Company Act) through the oversight of investment companies.[7]

One might ask, "From what harm is the investor to be protected?" The statutes hint at one

[5] That phrase or one similar to it appears approximately 16 times in the Securities Act, 147 times in the Securities Exchange Act, 16 times in the Investment Advisers Act, and 40 times in the Investment Company Act. These references appear in Product and Sales Provisions. *See, e.g.*, Securities Act of 1933, 15 U.S.C. §§ 77c(a)(2), 77g(a)(1), 78j(b) (2012); Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(a), 78o(b)(1) (2012); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-3(c)(1), 80b-4a (2012); Investment Company Act of 1940, 15 U.S.C. §§ 80a-8(a), 80a-12(a), 80a-12(b) (2012).

In the National Securities Markets Improvement Act of 1996, Congress imposed an additional responsibility upon the SEC, to consider whether certain proposed rules will promote efficiency, competition, and capital formation. *See* Securities Act of 1933, 15 U.S.C. § 77b(b) (2012); Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(f), 78o(n)(2) (2012); Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(c) (2012); Investment Company Act of 1940, 15 U.S.C. § 80a-3(c) (2012).

[6] *Id.*

[7] According to its preamble, the Securities Act implements "full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof[.]" Securities Act of 1933, pmbl. According to its preamble, the Securities Exchange Act is intended to "prevent inequitable and unfair practices on [securities] exchanges and [over-the-counter] markets." Securities Exchange Act of 1934, pmbl. Section 1 of the Investment Company Act states that the Act will "mitigate and, so far as is feasible . . . eliminate . . . conditions . . . which adversely affect the national public interest and interest of investors." 15 U.S.C. § 80a-1(b)(8) (2012).

The Investment Advisers Act describes its objectives with less precision. Section 201 states that the basis for the Act is the use by investment advisers of national securities exchanges, over-the-counter markets and securities issued by banks and companies engaged in interstate commerce, all in such volume as "substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy." 15 U.S.C. § 80b-1(3) (2012).

answer: fraud, and inequitable and unfair practices. Some provisions prohibit behavior that is morally or ethically reprehensible, such as fraud, market manipulation, churning of brokerage accounts, and excessive markups on principal transactions. These Product and Sales Provisions are intended, quite simply, to protect investors by eliminating these practices.

Other Product and Sales Provisions prescribe behavior that isn't morally or ethically laudable but is to be encouraged. One who commits fraud is morally reprehensible; one who fails to make line item disclosures required by Regulation S-K may not be, but there may be a public good in requiring him to do so. The Product and Sales Provisions can be divided between those prohibiting nefarious conduct and others prescribing salutary behavior. The former protect investors from the morally reprehensible conduct. The latter prescribe behaviors whose connection to investor protection is more attenuated. We will call the latter requirements the "Prescriptive Provisions."

3. The Prescriptive Provisions

The Prescriptive Provisions protect investors from conditions that might cause them harm even in the absence of malevolent conduct. These harmful conditions are implied by the objectives of each statute.

- Disclosure by issuers militates against the potential loss that comes from investing in the dark, from ignorance about the proposed investment. Public disclosure also allows the capital markets to reflect this information in the price of widely-traded securities and to price the "risk premium" associated with the security.[8] Exemptions from the prospectus delivery requirements are provided when investors are deemed qualified to participate without disclosure. The qualification of investors helps to ensure that they have the financial acumen or resources to obtain necessary information about the offering, to evaluate the offering, and to bear the investment risks.
- The regulation of financial intermediaries reduces the possibility that an intermediary will engage in practices that might cause its customers harm. These practices might constitute abject abuse, like fraud and manipulation, or they might devolve from the conflicts of interest that distract the financial intermediary from its responsibilities to the customer.
- The oversight of investment companies addresses the concern that conflicts of interest in their operation or the complexity of their structure might encourage behavior that causes shareholders harm.

In short, the Prescriptive Provisions address risks associated with securities investments.[9] These risks include the possibility of investing in the dark, retaining the services of a financial intermediary with conflicts of interest, and investing in an investment company whose liquid assets

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[8] The notion that information about a company might be reflected in the price of its common stock may have been recognized when the securities laws were enacted. *See, e.g.,* H.R. REP. NO. 73-85, at 3 (1933) ("The items required to be disclosed [by the proposed legislation] are items indispensable to any accurate judgment upon the value of the security."); H.R. REP. NO. 73-1383, at 11 (1934) ("The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market.").

The periodic reports of a public company are available on EDGAR and the market price of the security might be presumed to reflect the information in those reports. *See, e.g., Microcap Stock: A Guide for Investors*, SEC, http://www.sec.gov/investor/pubs/microcapstock.htm.

[9] They don't eliminate all investment risk.

might be pilfered or whose shareholder equity might be dissipated. The legislative purpose of "investor protection" may be understood as a response to the risks of buying securities, hiring broker-dealers or investment advisers, and purchasing investment company securities.

4. How the Prescriptive Provisions Address Investment Risk

The Prescriptive Provisions essentially address two categories of risk, those associated with a financial intermediary and those associated with a security.

Broker-dealers and investment advisers present agency risk, counterparty risk, and competency risk. The Prescriptive Provisions address these risks in varying degrees, agency risk being the most extensive subject of regulation. Agency risk refers to the possibility that financial intermediaries, in performing their financial service, will benefit themselves at their customers' expense. As discussed more below, FINRA comprehensively regulates the business of a broker-dealer and the Investment Advisers Act imposes a fiduciary duty on investment advisers that requires the investment adviser to act with a duty of care and a duty of loyalty to the customer.[10]

The Prescriptive Provisions also address the risks associated with a security. These are business and market risks, agency risk, and competency risk. Business and market risks include the risks associated with the investment's business prospects and its operations, those associated with the terms of the security, the risk that those terms will not be enforceable, the risks associated with the conditions under which the security trades, and those associated with economic or political influences on the expected total return. Agency risk concerns the probability that agencies of the issuer will act in their own interest in a manner inconsistent with the interests of shareholders. Competency risk concerns the probability that the managers of the issuer are not competent.

For ease of discussion, we will elaborate only on the business and market risks associated with a security.[11] The Prescriptive Provisions mitigate business and market risks associated with a

[10] The Prescriptive Provisions also address counterparty and competency risks associated with a financial intermediary. *See, e.g.,* Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (2014); Customer Protection-Reserves and Custody of Securities, 17 C.F.R. § 240.15c3-3 (2013); *see also* Securities Investor Protection Act of 1970 § 4(c), 15 U.S.C. § 78ddd (2012) (requiring broker-dealers to carry insurance).

SEC rules under the Investment Advisers Act regulate the custody of client assets by investment advisers. Many states impose net capital or surety bond requirements on state registered investment advisers. *See, e.g.*, CAL. CODE REGS. tit. 10, § 260.237.2 (2009) (detailing the minimum financial requirements for investment advisers); 950 MASS. CODE REGS. § 12.205(5) (2018) (detailing the surety bond requirement placed on investment advisers).

FINRA requires broker-dealer representatives to pass qualifying examinations. *See* FINRA, Rule 1031, REGISTRATION REQUIREMENTS (2003). Some states require that investment adviser representatives pass qualifying examinations. *See, e.g.*, 950 MASS. CODE REGS. § 12.205(4) (2018). Some states provide an exception to investment adviser representatives who have passed examinations offered by certain private organizations, such as the CFA Institute and the CFP Board. *Id.*

[11] State corporate law typically addresses a company's agency risk by imposing a fiduciary duty on corporate insiders. *See, e.g.*, J. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1992) ("Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholder and to shareholder alone.")

The Prescriptive Provisions also respond to agency and competency risks associated with a public issuer through disclosure. *See, e.g.*, SECS. AND EXCH. COMM'N, FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 (2016) (requiring disclosure of director experience and qualifications, legal proceedings, executive compensation, and related party transactions); *see also* Securities Act of 1933 § 6(a), 15 U.S.C. § 77f security through disclosure and the regulation of financial intermediaries.

i. Disclosure

Under Section 10 of the Securities Act, an issuer must register its publicly-offered securities;[12] Section 5 generally requires that a prospectus be provided to investors.[13] The Securities Exchange Act requires that public issuers provide periodic reports concerning their financial condition and material events. Also, the issuer's financial statements must be audited by an independent public accountant registered with the Public Company Auditing Oversight Board.[14] The periodic reports are "integrated" into the issuer's registration statements for its follow-on offerings.[15]

This integrated reporting system ensures that the investing public is informed about the condition of the public issuer and its business and market risks. The Prescriptive Provisions respond to the business and market risks through disclosure about matters such as the operation of the issuer's business, associated risks, the terms of the security, the primary market upon which it will be traded, and economic and political risks.[16]

(2012); 17 C.F.R. § 240.13a-14 (2009) (requiring the board, the Chief Executive Officer and the Chief Financial Officer to sign the company's registration statement and annual report); Sarbanes-Oxley Act § 404(b), 15 U.S.C. § 7262 (2012) (requiring officer appraisal of the issuer's internal controls).

The panoply of Investment Company Act regulations helps to ensure that the organization, structure and operation of investment companies are not vulnerable to insider misconduct. Moreover, the investment adviser to an investment company must be registered under the Investment Advisers Act and investment adviser representatives to a registered investment company must pass qualification examinations. *See* EXAMS, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, nasaa.org/industry-resources/exams (last visited Mar. 13, 2018).

The Prescriptive Provisions also address agency risk through the regulation of financial intermediaries. FINRA's suitability rule and the investment adviser's fiduciary duty presumably require financial intermediaries to conduct reasonable diligence about any red flag concerning the disciplinary record and competency of an issuer's management.

[12] *See* Securities Act of 1933, 15 U.S.C. § 77j (2012) (requiring delivery of preliminary prospectus in initial public offering).

[13] *See id.* at § 77e(b)(1) (2012); Delivery of Prospectuses, 17 C.F.R. § 230.172 (2005) (requiring final prospectus to be filed with the SEC or delivered to customer); Notice of Registration, 17 C.F.R. § 230.173 (2005) (requiring underwriter or dealer to give purchaser the final prospectus or a notice that delivery of prospectus would have been required if not for Rule 172); Delivery of Prospectus, 17 C.F.R § 240.15c2-8(h) (2014) (requiring the managing underwriter to take reasonable steps to ensure that selling group members receive final prospectuses so they can comply with the final prospectus delivery requirement).

[14] *See* Securities Exchange Act of 1934 §§ 12, 13, 15(d), 15 U.S.C. §§ 78l, 78m, 78o(d) (2012); Sarbanes-Oxley Act of 2002 § 102, 107 P.L. 204, 116 Stat. 745 § 102 (2002).

[15] *See generally* Regulation S-K, 17 C.F.R. pt. 229 (2017).

[16] For example, Form S-1, a form commonly used to register publicly offered securities, requires the following line item disclosure:

> Item 1/Item 9 – Description of the securities, including their market.
> Item 3 – Disclosure of risk factors, including the lack of operating history, the financial position, the business or proposed business, and the lack of a market.
> Item 11 – Information concerning the registrant, including a description of its business and the securities market, financial information, management's discussion and analysis concerning the "financial condition, changes in financial condition and results of operations," and quantitative information about market risk.

Disclosure of underwriting compensation in the registration statement and FINRA regulation of underwriting compensation under its Rule 5110 might also address business and market risk associated with the security. *See*, FINRA, Rule 5110, CORPORATE FINANCING RULE (2016). *Cf.* 77 CONG. REC. 2929 (1933) ("Among the most

Disclosure is required in certain private placements too. For example, Rule 506 of Regulation D exempts a private placement from the registration requirements of Section 10 if it will be offered to no more than 35 unaccredited investors or to an unlimited number of accredited investors,[17] provided that unaccredited investors receive disclosure concerning the terms of the offering, risk factors, potential dilution, the plan of distribution, and the issuer's business.

The Prescriptive Provisions provide exceptions to disclosure requirements for investors who are deemed "qualified." For example, under Rule 506, accredited investors are presumed to have the financial acumen or resources to obtain necessary information about the security, to evaluate it, and to bear the investment risks.[18] For these investors, disclosure is not required.

ii. Regulation of Financial Intermediaries

The regulation of financial intermediaries also addresses business and market risk. The Securities Exchange Act regulates broker-dealers and requires most of them to belong to a regulated national securities association, the only one of which is FINRA.[19] FINRA comprehensively regulates virtually all aspects of a broker-dealer's operations and requires that a broker-dealer's recommendations be suitable.[20] The suitability rule requires the broker-dealer to conduct reasonable diligence into the features of the recommended security, including the types of risks enumerated above as "business and market risks."[21]

Section 11 of the Securities Act imposes strict liability on broker-dealers who participate in the distribution of publicly-offered securities with respect to untrue statements or omissions of material fact in the registration statement. The underwriter may have a defense if it can demonstrate that the underwriter had "after reasonable investigation, reasonable ground to believe and did

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important facts to be learned for determining the real value of a security is the amount of water it contains. And any excessive amount paid to the banker for marketing a security is water." (quoting Justice Louis Brandeis)).

[17] Rule 501 defines "accredited investor" to include any natural person whose individual net worth, or joint net worth with a spouse, exceeds $1,000,000, or who had income in excess of $200,000 in each of the two most recent years, or joint income with a spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. *See* 17 C.F.R. § 230.501 (2016); *see also* 15 U.S.C. § 80a-3(c) (2010) (registration exemptions for certain investment funds).

[18] As the SEC staff has stated, "The accredited investor definition attempts to identify those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." U.S. SECS. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" (2015).

The early legislative history of the Securities Act is silent about whether personal wealth implies financial sophistication. It is possible that Congress exempted private placements for more practical or political reasons. *See, e.g.*, H.R. REP NO. 73-85, at 5 (1933) ("[The Draft Securities Act] carefully exempts from its application certain types of . . . securities transactions where there is no practical need for its application or where the public benefits are too remote.").

The notion that personal wealth implies financial sophistication apparently arose from the 1953 Supreme Court decision in *SEC v. Ralston Purina Co.,* 346 U.S. 119, 125 (1953), in which the Court held that the statutory private placement exemption was intended to apply to purchasers who are "able to fend for themselves." *See* Greg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285, 287 (2012).

[19] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(8) (2012).

[20] *See* FINRA, Rule 2111, SUITABILITY (2014).

[21] Supplementary Material .05(a) of Rule 2111 states, "A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy." *Id.*

believe . . . that the statements . . . were true and that there was no [material] omission."[22] As a practical matter, this defense imposes a due diligence obligation on underwriters. Broker-dealers who serve as underwriters help to address business and market risks by conducting due diligence about the accuracy of the registration statement that discloses information about the issuer.

The Investment Advisers Act imposes a fiduciary duty on registered investment advisers, including a duty of loyalty and a duty of care. According to the SEC, embedded in this fiduciary duty is a suitability obligation similar to the one that FINRA imposes on broker-dealers.[23]

iii. Investment Company Regulation

The Investment Company Act mitigates business and market risks associated with investment company issuers. The Act comprehensively regulates all aspects of registered investment companies, including their capital structure and organization, the terms of their securities, and the liquidity of their held assets.

To summarize, the Prescriptive Provisions address the business and market risks associated with a security through:

- Disclosure and investor qualification;
- Financial intermediary regulation; and
- Investment company regulation (in the case of investment company issuers).

5. A New Way to Appreciate Securities Law

Securities law can be understood as a response to specific types of investment risk. Provisions in different statutes often address the same type of risk. For example, prospectus delivery and broker-dealer regulation both address the business and market risks associated with a security. Prospectus disclosures bring to light the salient facts about the issuer and security; FINRA's suitability rule imposes a diligence requirement on broker-dealers when they recommend publicly-issued securities.

These provisions should be considered together. Redundant confrontation of the same risk can be eliminated and gaps in the confrontation of investment risk exposed. Efficiencies in the law's application would be obtained and burdens on capital formation and financial services minimized.

In short, the Product and Sales Provisions and other identifiable subsets of the securities law should be viewed organically, without regard to the statute in which they happen to appear. A Securities Act provision for prospectus delivery should be considered alongside the Investment Company Act's regulation of investment companies and FINRA's suitability rule. The various ways in which they address business and market risk should be contemplated in unison. This understanding of the securities law as an organic body of law would better ensure that they are coherently understood and consistently applied.

[22] *See* Securities Act of 1933, 15 U.S.C. § 77k(b)(3) (2012).

[23] U.S. SECS. AND EXCH. COMM'N, GENERAL INFORMATION ON THE REGULATION OF INVESTMENT ADVISERS (2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm ("As fiduciaries, investment advisers owe their clients a duty to provide only suitable investment advice.") (citing Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements For Certain Advisory Clients, Investment Advisers Act Release No. 1406, 17 C.F.R. 275 (Mar. 22, 1994).

To illustrate our proposed method of understanding we will apply it to two examples.

- The business and market risks associated with privately-placed securities recommended by a financial intermediary.
- The business and market risks associated with publicly-offered securities recommended by a broker-dealer.

These examples are concomitant with the conundra of Loni Almoni in Part I.

A. The Purchase of Securities in a Recommended Transaction under Rule 506

Loni Almoni asked, "Of what benefit is the private placement memorandum to an unsophisticated customer who purchases through a licensed broker?" After all, the broker must conduct a reasonable inquiry about a private placement and recommend only suitable investments to the customer.

Rule 506 permits the sale of privately-placed securities to no more than thirty-five unaccredited investors and an unlimited number of accredited investors.[24] Unaccredited investors must receive disclosure concerning the terms of the offering, risk factors, potential dilution, the plan of distribution, and the issuer's business, including financial information.[25] Each unaccredited investor "either alone or with his purchaser representative(s)" also must have: "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.[26]

"Purchaser representative" is similarly defined to include any person who "[h]as such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives, or together with the purchaser, the merits and risks of the prospective investment."[27] Purchaser representatives may be broker-dealers and investment advisers.[28]

Accredited investors need not receive disclosure nor representation from a purchaser representative.[29] The rule relies on the notion common in the federal securities laws that some investors possess the financial acumen or resources to evaluate the offering and bear the associated investment risks.

Our proposed method of rulemaking requires an integrated analysis of the Prescriptive Provisions. If a provision in one statute mitigates an investment risk, then another rule might defer to it to mitigate the same risk in a different situation. Rule 506 illustrates this integrated understanding of the Prescriptive Provisions. If an unaccredited investor is unsophisticated, then

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[24] *See* 17 C.F.R. § 230.506(b) (2013).

[25] *See* 17 C.F.R. § 230.502(b) (2016).

[26] 17 C.F.R. § 230.506(b)(2)(ii) (2013).

[27] 17 C.F.R. § 230.501(i)(2) (2016).

[28] *See, e.g.*, *id.* at § 230.501 n.1 ("A person acting as purchaser representative should consider the applicability of the registration and antifraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 . . . and relating to investment advisers under the Investment Advisers Act of 1940.").

[29] However, the SEC encourages issuers to provide accredited investors with this information. *See* 17 C.F.R. § 230.502(b)(1) (2016).

the broker-dealer or investment adviser who recommends the private placement should possess the requisite knowledge and experience. Rule 506 relies on the knowledge and experience of a broker-dealer or investment adviser to evaluate business and market risks of privately-placed securities on behalf of unaccredited investors.

Nevertheless, Rule 506 does not rely on the performance by an intermediary of its suitability and fiduciary obligations. Indeed, Rule 506 does not require a purchaser representative to be a regulated broker-dealer or investment adviser.[30] Regardless, the cohesive assimilation of the broker-dealer and investment adviser into the rule, even limited to considerations of knowledge and experience, is consistent with the method of rulemaking that this Article recommends.[31]

However, this method does present one question. As Loni Almoni inquired, will unsophisticated investors who are represented by a broker-dealer or investment adviser value the private placement memorandum that the rule requires? If broker-dealers and investment advisers are subject to adequate regulation concerning the diligence and suitability of recommendations, why must Rule 506 require delivery of a private placement memorandum to unaccredited investors?[32] At most, perhaps, investors should have the ability to obtain a private placement memorandum upon request.

B. The Purchase of Publicly-Offered Securities in a Recommended Transaction

Loni Almoni asked:

- Why must Figurative Wealth Management deliver prospectuses about registered investment companies that are comprehensively regulated to customers who are represented by licensed brokers?
- Why must the firm deliver prospectuses to customers who are qualified to buy privately-placed securities without having received any disclosure?

The requirement that an investor will receive, or at least have access to a prospectus, is fundamental to the Securities Act.[33] Nevertheless, one might inquire whether prospectus delivery should be required when an investor is represented by a registered broker-dealer.[34] Do the

[30] *But see* supra note 27.

[31] *Cf.* 15 U.S.C. § 77d-1 (2012) (a crowdfunding intermediary must register with the SEC and self-regulatory organization as a broker-dealer or funding portal).

[32] Of course, if the regulation or oversight of broker-dealers and investment advisers is inadequate to ensure that their inquiry is reasonable and their recommendations are suitable, then the regulation and oversight should be improved.

[33] It applies whether the customer acts alone or through a financial intermediary. It is distinguishable from the requirements for secondary market transactions, in which a financial intermediary may recommend that a customer purchase the securities of a public company without ensuring that the customer has received or has access to the issuer's periodic reports, even though the purchase will present business and market risks.

[34] *Cf.* Milton Cohen, "*Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1385 (1966).

> [T]he 1934 Act says that *all* "investors" . . . in actively traded securities need the protection of a disclosure system, and that public filing on a continuous basis is essential, and at the same time is adequate, for that purpose. Regardless of dollar amounts or numbers of investors involved, of participation of intermediaries or other particular circumstances, there is no requirement (except in proxy solicitations) that information be culled from the file and physically delivered. If the law is right in saying that this is good enough for investors in the trading markets, why is it not good enough for offerees in a somewhat arbitrarily defined "public offering"?

Prescriptive Provisions governing the broker-dealer's due diligence and suitability responsibilities adequately address the business and market risks associated with the recommended purchase? If they do, then what is the added value of prospectus delivery to a retail investor who is represented by a broker-dealer? Are there other purposes served by prospectus delivery to such an investor?[35] If the due diligence and suitability requirements do not adequately address the business and market risks, then what level of regulation of the broker-dealer's distribution of publicly-offered securities would ensure that the business and market risks are addressed?[36]

Moreover, the requirement that a retail investor receive or at least have access to a prospectus before the purchase of publicly-offered securities exists regardless of its sophistication or financial resources. Under Rule 506, an accredited investor is not required to receive disclosure concerning a private placement in which it invests.

Why should prospectuses be delivered to accredited investors who purchase publicly-offered securities? If these investors are deemed to have the financial acumen or capacity to analyze the business and market risks associated with privately-placed securities, why can they not analyze the business and market risks associated with registered and publicly-distributed securities?[37]

The public offering of investment company securities leads to more questions. The federal securities laws and FINRA rules impose a suitability obligation upon a broker-dealer that recommends registered investment company securities, as they do upon the recommendation of any other security. Investment advisers must comply with their fiduciary duty when they recommend investment company securities. The fiduciary duty embraces a suitability obligation and a requirement to conduct reasonable diligence about the security.[38]

Under what circumstances must a broker-dealer or investment adviser conduct reasonable diligence about the operation, organization, or structure of an investment company, which the Investment Company Act comprehensively regulates?

To summarize our answers to Loni Almoni:

(footnote omitted) (emphasis in original). Cohen's article led to the integrated disclosure system. *See* Adam Pritchard, *Revisiting 'Truth in Securities' Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999 (2013).

[35] Prospectus disclosure concerning a new issuer that has not begun to issue periodic reports ensures that information concerning it reaches the marketplace. In a seminal article on the subject of disclosure under the federal securities laws, Milton Cohen explained that because the Securities Act preceded the Securities Exchange Act, public offering disclosure is separate from periodic reporting disclosure. *See* Cohen, 79 HARV. L. REV. Some have proposed company rather than securities registration. *Id.; see also* American Law Institute. FED SEC. CODE (1980). The adoption of the integrated disclosure system for the two Acts moved disclosure toward the concept of company registration. *See* Pritchard, 36 SEATTLE U. L. REV., at 1000.

[36] *Cf.* Cohen, 79 HARV. L. REV., at 1408.

> The crucial question, obviously, is the appropriate application of "1933 Act" concepts to issuers that are already "1934 Act" continuous registrants. Rightly viewed, it is not a question of weakening the prohibitions of the 1933 Act but rather of strengthening those of the 1934 Act's continuous disclosure system – the basic system – and then eliminating 1933 Act burdens that are essentially superfluous.

[37] *Cf.* 15 U.S.C. § 78l (2012) (requiring registration and periodic reporting by companies with either 2000 record holders or 500 unaccredited record holders).

[38] *See supra* notes 21, 23.

- Delivery of a private placement memorandum to unaccredited investors represented by a broker-dealer could be duplicative of the protections afforded by the regulation of their broker-dealer.
- Delivery of investment company prospectuses to investors who purchase as a result of their broker-dealer's recommendation also appears to be redundant.
- Delivery of prospectuses to accredited investors may be unnecessary.

The organic understanding of securities law as a response to investment risk thus could allow a more efficient tailoring of investor protections. The Prescriptive Provisions would operate in a more coherent framework, investors would be better served, and undue burdens on the industry would be removed.