THE SECURITIES ACT AT ITS DIAMOND JUBILEE: RENEWING THE CASE FOR A ROBUST REGISTRATION REQUIREMENT

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"Yes, there are weapons of mass destruction. They are 'financial weapons of mass destruction' . . . ."

— Warren Buffett[1]

"I keep hearing well-meaning people say that America is not a nation if it doesn't have control over its borders. But are we a nation if there is no meaningful restraint on what people can do with an offering statement . . . ?"

— Ben Stein[2]

I. INTRODUCTION: TURMOIL AND DISTRUST IN THE CAPITAL MARKETS

Midway through 2008, the seventy-fifth anniversary of the Securities Act of 1933,[3] America's capital markets were again reeling from the type of economic turmoil[4] which that landmark legislation was supposed to

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1. Buffett made these remarks describing securities backed by subprime mortgages and the havoc they have wrought on the credit markets. Mortimer B. Zuckerman, *The Credit Crisis Grows*, U.S. NEWS AND WORLD REPORT, Dec. 24, 2007, at 68 (quoting Warren Buffett).

2. Ben Stein, *Tattered Standard of Duty on Wall Street*, N.Y. TIMES, Dec. 23, 2007, at BU6.

3. 15 U.S.C. §§ 77a-77z (2000 & Supp. IV 2005).

4. As a New York Times article recently reported:

> Ever since Wall Street bankers were called back from their vacations last summer to deal with the convulsions in the mortgage market, the economy has been lurching from one crisis to the next. The International Monetary Fund has described the situations as 'the largest financial shock since the Great Depression.'

prevent. This time the chaos was caused by the collapse of debt obligations collateralized by sub-prime mortgages, a $12 trillion dollar industry engineered by the leading investment banks of Wall Street.[5] These so-

David Leonhardt, *Obamanomics*, N.Y. TIMES SUN. MAG., Aug. 24, 2008, at 30.

In a speech in London on July 2, 2008 Treasury Secretary Henry M. Paulson, Jr. "predicted that turmoil in the financial markets and a slowdown in economic growth" would continue for some time. Julia Werdigier, *Paulson Calls for Stronger Regulators*, N.Y. TIMES, July 3, 2008, at C2.

Likewise Federal Reserve chairman Ben Bernanke predicted in a speech on July 8, 2008, that the problems plaguing the housing and capital markets would continue well into 2009. Stephen Labaton, *Fed Concludes Economic Woes Likely to Spill into 2009*, INT'L HERALD TRIB., July 9, 2008, at A1.

When the major investment banking firm Bear Stearns collapsed in March, 2008, a financial reporter made this grim observation, "Fifteen thousand jobs lost in the financial sector since the fall. Recession. Panic on Wall Street. Crisis in the housing market. Bear Stearns sold at $2 a share." Cate Doty, *Where Wall Street's Caviar Set Still Thrives*, N.Y. TIMES, Mar. 24, 2008, at C1.

The Bear Stearns debacle itself would cost another 14,000 employees their jobs. Kate Kelly, *The Fall of Bear Stearns: Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J., May 27, 2008, at A1.

According to a more recent report, 83,000 employees of New York investment firms have lost their jobs as of mid-year 2008 while those companies have been "racking up billions of dollars in losses as a result of their foolish forays into subprime mortgages." Andrew Ross Sorkin, *A 'Bonfire' Returns as Heartburn*, N.Y. TIMES, June 24, 2008, at C5. According to the N.Y. Times, the ensuing housing bust has "metastasized into the worst financial crisis since the Depression." Editorial, *About Those Loans*, N.Y. TIMES, July 9, 2008.

A further sign that the economic crisis continued to worsen was the precipitous fall in the shares of the Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac), two federally-chartered companies that are the nation's largest buyers of home mortgages. James R. Hagerty, Deborah Solomon & Damian Paletta, *U.S. Mulls Future of Fannie, Freddie*, WALL ST. J., July 10, 2008, at A1.

Many commentators predicted that the problems with Fannie Mae and Freddie Mac would ultimately fall upon the taxpayers. As one commentator noted, "Washington today has its fingerprints on 80% of new mortgages, up from 40% a year ago[.]" Holman W. Jenkins, Jr., *More Bailouts, Please!*, WALL ST. J., July 9, 2008, at A13. The U.S. Treasury Department has finally announced plans to take control of the companies and provide up to $200 billion in capital to them. James R. Hagerty, Ruth Simon & Damian Paletta, *U.S. Seizes Mortgage Giants*, WALL ST. J., Sept. 8, 2008, at A1.

After allowing Lehman Brothers to file for bankruptcy, but rescuing the insurance giant AIG, the U.S. Treasury eventually gave up its piecemeal approach to this financial crisis. It persuaded Congress to authorize a $700 billion appropriation to rescue the entire financial system. Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., Oct. 4-5, 2008, at A1.

5. For a well-researched and well-written exposé of how once-reputable financial houses like Merrill Lynch and Bear Stearns created this investing travesty, see PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS (John Wiley & Sons 2008).

Another well-received, recent book describing the causes of the sub-prime mortgage debacle is MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS (FT Press 2008).

See also James Surowiecki, *The Financial Page, Too Dumb to Fail*, THE NEW YORKER, called "securitized assets" were contracts that promised their purchasers profit from the efforts of others.[6] As such, they were just the type of passive investments whose holders would need the complete and accurate information that federal registration was designed to provide.[7]

Mar. 31, 2008, at 46 (noting that most of the money loaned today no longer comes from commercial banks but from these debt obligations that are packaged and sold by investment banks as securities).

A leading European journal has offered this perspective:

> [a]s markets that were crucial for raising funds started to dry up last August [2007], a network of financial vehicles slid into crisis, causing the price of many debt securities to collapse. That started a chain reaction that created liquidity and solvency crises at U.S. and European banks—on a scale last seen in Japan almost exactly a decade ago . . . .
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> . . . A year later, there is still no sign of an end to these problems. Instead, the sense of pressure on western banks has risen so high that by some measures this is now the worst financial crisis seen in the west for 70 years.

Gillian Tett, *A Year that Shook Faith in Finance*, FIN. TIMES, Aug. 4, 2008, at 11.

Another commentator on the international scene, however, is more sanguine:

> Of course, low interest rates and cheap credit also cause people to act foolishly or greedily, inflating bubbles in technology stocks, housing, subprime mortgages, or emerging market equities—bubbles that eventually pop. As the world gets more interconnected, and financial instruments more exotic, many observers worry that the virtuous cycle of growth and confidence could turn into a vicious one of panic and depression. But, so far, even as the unwinding of crises is extremely painful, the diverse new sources of growth and massive quantities of new capital have given the global economic system as a whole greater resilience."

FAREED ZAKARIA, THE POST-AMERICAN WORLD 27 (W.W. Norton & Co. 2008).

6. "Securitization involves transferring a loan or pool of loans into a trust and then having that trust issue securities, or bonds, that are rated by the large rating agencies and purchased in the institutional bond market." Ethan Penner, *The Future of Securitization*, WALL ST. J., July 10, 2008, at A15.

A study by the SEC has found that agencies that rate securities were complicit in deceiving purchasers about the true worth of those securities. For instance, an analyst at one of the agencies wrote this in an email to a colleague about securities backed by subprime mortgages: "Let's hope we are all wealthy and retired by the time this house of cards falters." Michael M. Grynbaum, *Study Finds Flawed Practices at Ratings Firms*, N.Y. TIMES, July 9, 2008, at C1.

However, the SEC itself contributed to the creation of this crisis by relaxing its net capital rules for large investment banks. This allowed the brokerage units of those institutions to substantially increase the amount of debt they could assume. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1.

Such deception has compounded the market's loss of confidence. As David Einhorn, a hedge fund manager, recently put it, "This is sort of like a confessional where the priest delivers a public opinion on the extent of your virtues or sins, and your spouse has to guess what a AAA or a BBB means about your fidelity." Floyd Norris, *A Debacle that has Wall Street in the Dark*, N.Y. TIMES, Nov. 2, 2007, at C1.

7. *See infra* note 44 and accompanying text. Section 4(5) however was added to the Securities Act in 1975 to exempt one prominent securities asset, mortgaged-backed

This unstable situation[8] involving the packaging and selling of participation in shaky real estate loans has exposed the vulnerability of investors.[9] Not only was the risky nature of those securities hidden from their purchasers, but it may not have been known by their underwriters.[10] Such practices on Wall Street provoked this telling comment from novelist and social critic Tom Wolfe: "Nobody understands where the actual value is - and they don't care anymore."[11]

The subprime mortgage debacle has thus hit the American economy hard, wiping out billions of dollars in stock market value and resulting in huge losses to top financial institutions.[12] As a leading economist put it,

securities, from the Act's registration requirement.

8. This crisis, however, was only the latest in a string of securities scandals that have shaken the foundations of our economic system. At the beginning of the decade, right after the bursting of the dot-com bubble, there was a spate of accounting frauds like Enron. Then came news of widespread deceitful conduct by stock analysts along with abusive market timing and late trading by mutual fund managers. More recent revelations about the pervasive practice of options backdating by already lushly-compensated corporate executives have further eroded public trust in those who manage our society's economic resources. For the author's comments on these situations, see Daniel J. Morrissey, *After the Ball Is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals*, 83 NEB. L. REV. 732 (2005) and Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973 (2007).

9. A particularly poignant example are the losses suffered by the Indiana Children's Wish Fund, a charity for children with life-threatening illness, that put $48,000 in a fund invested heavily in mortgage-backed securities without being told of the risks such investments posed. Gretchen Morgenson, *The Debt Crisis, Where It's Least Expected*, N.Y. TIMES, Dec. 30, 2007, at BU1.

On the other end of the spectrum, the sub-prime mortgage crisis has even caused housing prices to plummet in Greenwich, Connecticut, an exclusive suburb outside of New York City. "[The crisis] has reverberated through the financial system, costing many [Greenwich] residents, actual or aspiring, their jobs or credit lines." Nick Paumgarten, *A Greenwich of the Mind*, THE NEW YORKER, Aug. 25, 2008.

Such consequences may be particularly appropriate, however, since Greenwich is also the home of so many hedge funds that it has been called, "Hedgeistan." *See* Cho, *infra* note 181.

10. Such knowledge was not necessary because the investment banks took credit assets and transferred them into a trust which then sold interests in them to the bond market. The investment banks made significant profits in this process and then walked away from any risk. *See* Penner, *supra* note 6.

Firms like Merrill Lynch, Bear Stearns and Lehman Brothers thus exposed their clients to immense losses. Stein, *supra* note 2.

11. Sorkin, *supra* note 4. As the author of *Bonfire of the Vanities*, a highly-acclaimed novel about a successful Wall Street bond trader in the mid-1980s, Wolfe has some expertise in chronicling the human follies that the capital markets can engender.

12. Morgenson, *supra* note 9. As has been aptly described elsewhere, the Federal Reserve intervened during the St. Patrick's Day weekend of 2008 to arrange a hasty sale of Bear Stearns to J.P. Morgan-Chase with a pledge of lending from the Central Bank to support the value of Bear's securities. *See* Kelly, *supra* note 4.

Fed chairman Bernanke has announced that his board will continue this policy of supplying "[h]ere you had all these people who were supposed to be sophisticated investors, and it turns out they were buying billions of dollars worth of debt where they didn't understand what they owned."[13]

Policymakers who must deal with these troubling circumstances should remember the groundbreaking reform legislation enacted three quarters of a century ago when our country faced an even greater crisis of trust in its financial institutions. In the depths of the Great Depression, the new administration of Franklin Delano Roosevelt secured passage of the Securities Act of 1933 as part of its fabled 100 Days of remedial lawmaking.[14] Its principal provision, designed to protect investors from fraud and ensure confidence in our capital markets, mandates that securities be registered before they are offered and sold to the public.[15] Over the years, however, the exemptions to that requirement have been broadened, allowing more and more securities to be issued without that important safeguard.[16]

This Article will argue that the weakening of registration, which has occurred during the last twenty-five years of deregulatory fervor, should be reversed. The current disarray in our financial system makes the need for such reform compelling. In particular, the Securities and Exchange Commission (SEC or Commission), the federal agency charged with administration and enforcement of the Securities Act, should not go forward with its proposed rules to expand exemptions to the Act's registration requirement.[17] Rather, it should consider ways to protect registration safeguards in order to forestall further meltdown of our capital markets.

In making this case, this Article will first discuss the nature and origins of securities registration. It will then examine how registration has worked in practice during its seventy-five years of existence. An analysis of the deregulatory reforms that have lessened such protection will be included in that discussion.[18] These deregulatory reforms were enacted during the last quarter-century in response to charges that stringent registration requirements posed an undue burden to capital formation.

An article on this topic, however, would not be complete without

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loans when necessary to large investment banks. Damian Paletta & Sudeep Reddy, *Bernanke Moves to Extend Powers as Credit Woes Linger*, WALL ST. J., July 9, 2008, at A1. For a trenchant critique of this policy of using the Fed to shore up failing firms, see Jenkins, *supra* note 4.

13. Peter S. Goodman, *The Free Market: A False Idol After All?*, N.Y. TIMES, Dec. 30, 2007, at WK 4.

14. *See infra* notes 30-39 and accompanying text.

15. *See infra* notes 50-51 and accompanying text.

16. *See infra* notes 100-39 and accompanying text.

17. *See infra* notes 216-43 and accompanying text.

18. *See infra* notes 100-39 and accompanying text.

treatment of hedge funds and private equity companies, two vehicles for large pools of investment funds that have become prominent in recent years. This Article will therefore examine whether they have changed the nature of capital formation and how that should affect registration.[19] It will then directly address and critique the SEC's latest proposals to further circumscribe the registration requirement.[20] As recent events have shown, just the opposite response is now needed to protect investors from fraud and instill renewed public trust in the integrity of our financial markets.

II. THE ORIGINS OF FEDERAL REGULATION OF SECURITIES

A. *Antecedents of Federal Legislation*

Although the law requiring the federal registration of securities was a major innovation on the national level when Congress passed the Securities Act in 1933, this legislation had ample precedent both in Great Britain and in the securities acts of our several states.

English regulation of securities trading can be traced back to medieval statutes. Securities regulation became prevalent in the 17th and 18th century to combat the panics and bubbles associated with the sale of securities by companies set up to colonize the New World.[21] Then, as Great Britain led the way into the Industrial Revolution, Parliament passed a series of Companies Acts in the 19th century requiring the registration of prospectuses selling corporate shares and providing stringent liability for the directors and promoters of those companies if their offering documents were fraudulent.[22]

In America, rapid industrialization began in earnest after the Civil War, with much of the capital contributed by middle class investors. In that era of the notorious robber barons, calls for some type of national regulation of the sales of securities came after the panics of 1873 and 1907 and the recessions that followed them.[23] The first investor protection laws,

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19. *See infra* notes 175-207 and accompanying text.

20. *See infra* notes 220-43 and accompanying text.

21. *See generally* LOUIS LOSS AND JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1-2 (Aspen Law & Business 2001) (explaining the origin of English securities regulation).

22. These laws developed gradually in Britain throughout the second half of the 19th century as Parliament experimented with various approaches that either mandated corporate disclosure or made disclosure voluntary. Finally in 1900 the United Kingdom settled on making such practices mandatory for all types of registered companies. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 807 (2006).
The Securities Act was modeled on the Companies Act of 1900. James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1960).

23. *See generally*, JOHN STEELE GORDON, AN EMPIRE OF WEALTH: THE EPIC HISTORY OF AMERICAN ECONOMIC POWER 223-28 (HarperCollins Pub. 2004) (explaining an incident

however, arose from the state legislatures. They came particularly from those in the western region where shady eastern-based securities salesmen were raising capital from local residents.[24] Kansas, then a stronghold of populist sentiment, led the way in 1911 with the first laws aimed at such promoters who were said to be so deceitful that they "would sell building lots in the blue sky in fee simple."[25]

Other states quickly followed suit, enacting similar laws that required a public official to rule on the "merits" of a securities offering before it could be sold to their citizens.[26] Such legislation, however, proved ineffective to halt securities fraud on a national level.[27] With the stock market rising steadily during the following decade of the roaring twenties, movements for investor protection from the federal government never gained traction.[28]

in which robber baron Jay Gould was able to take advantage of poor regulation and disrupt the U.S. gold market).

After the Panic of 1907 President Theodore Roosevelt asked Congress for federal legislation "to prevent at least the grosser forms of gambling in securities and commodities, such as making large sales of what men do not possess and 'cornering' the market." Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 396 (1990).

President Teddy Roosevelt was also famous for denouncing unscrupulous business leaders as "malefactors of great wealth." MICHAEL MCGERR, A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA, 1870-1920 177 (2003).

24. LOSS & SELIGMAN, *supra* note 21, at 9.

25. *Id.* Kansas was such a hotbed of radicalism in the early 20th century that more moderate Americans were then asking, "What's the Matter with Kansas." *See, e.g.*, THOMAS FRANK, WHAT'S THE MATTER WITH KANSAS? HOW CONSERVATIVES WON THE HEART OF AMERICA (2005) (giving that question an ironic twist by using it as the title of a recent book exploring how that state has now come to be dominated by right-wing extremists).

26. Those state regulatory schemes were left intact by the Securities Act in 1933, but were later partially pre-empted by the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416. *See infra* notes 153-61 and accompanying text.

27. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 20 (Thomas West 2005); *see* Carol L. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 297 (1989) ("These state statutes suffered from the lack of uniform standards and under-funded enforcement agencies.").

28. U.S. Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, at 2, July 9, 2008, *available at* http://www.sec.gov/about/whatwedo.shtml (describing how investors, "tempted by promises of 'rags to riches' transformations and easy credit" poured money into the stock market in the decade following World War I).

See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L. Q. 849, 851 (1997) (making the apt observation about how such situations impact regulatory reform, Banner states, "as long as the market has been rising or at least holding steady," legislative proposals to curb securities fraud go nowhere because "too many people have been making too much money to favor regulation restricting trading").

B. The Impetus for Federal Reform

Nevertheless, the stock market crash of October 1929 brought unprecedented losses to the millions of shareholders who had sought to share in the prosperity of the industrial economy. Approximately half of the securities sold during the preceding decade became worthless. Investor confidence collapsed as those losses multiplied during the ensuing Great Depression.[29]

Given these significant market failures, Franklin Roosevelt campaigned for president in 1932, pledging financial reform as an essential ingredient for economic recovery.[30] To that end, the Democratic Party's platform promised a system of mandatory securities registration with this plank: "We advocate protection of the investing public by requiring to be filed with the government . . . of all offerings of foreign and domestic stocks and bonds true information as to bonuses, commissions, principal invested, and interests of the sellers."[31] Even before Roosevelt took office, Congressional hearings revealed in detail various fraudulent practices by securities dealers that had severely crippled the nation's economy.[32]

The same month that President Roosevelt took office, he recommended that Congress pass legislation that would mandate full disclosure in the sale of securities. "There is . . . an obligation upon us to insist that every issue of new securities . . . shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."[33] An initial draft of such legislation was substantially revised in a whirlwind weekend session by a team of legal scholars assembled by Felix Frankfurter, then a professor at the Harvard Law School.[34]

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29. *See* U.S. Securities and Exchange Commission, *supra* note 28, at 3.

30. Franklin D. Roosevelt, First Inaugural Address (Mar. 4, 1933), *available at* www.bartleby.com/124/pres49.html (sounding that theme again in his inaugural address, President Roosevelt stated, "[t]he rulers of the exchange of mankind's goods have failed . . . . there must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing").

31. *See* JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970 3 (1970).

32. *See* Landis, *supra* note 22, at 30; *see also* HAZEN, *supra* note 27, at 21.

33. S. REP. NO. 73-47, at 6 (1933); H.R. REP. NO. 73-85, at 1-2 (1933).

34. Landis, *supra* note 22, at 33-34.

Describing that weekend drafting process and what it created, one commentator has stated:

> By late Saturday they had a draft that, more than fifty years later, still constitutes the main body of the Securities Act. The Act is a masterpiece, an intellectual *tour de force*. It is fun to work with once you know how. For now, realize that when one works with the Securities Act, one plays a complex mental game devised by three exceptional minds over a weekend.

Gary M. Brown, *Approaching Securities Law*, *in* UNDERSTANDING THE SECURITIES LAWS

James M. Landis, a distinguished member of that group, later described how the Act was based on a disclosure theory which required the filing of a registration statement and a waiting period before the securities could be sold. While the Act did not give the federal government authority to pass on the investment quality of the offering, an overseeing commission would be granted the power to keep issues off the market if the data in the registration statement were inadequate or false.[35] Provisions for criminal and civil liability were also included to ensure that corporate officials would be honest and forthright with their investors.[36]

After some legislative vetting,[37] the bill quickly passed both houses of Congress and was signed into law by President Roosevelt on May 27, 1933, less than three months after he had taken office.[38] The new law appears to have had an immediate beneficial impact, returning public confidence to the stock market. According to John Steele Gordon, a leading historian of business, "[t]he year 1933 would prove to be one of the best years of the twentieth century on Wall Street, although, of course, rebounding from a disastrously low base. The Dow that year rose almost 60 percent, and some brokerage firms even began hiring again."[39]

III. THE REGISTRATION REQUIREMENT

A. *The Purpose of Securities Registration*

As the Supreme Court has said, "[T]he design of the statute (The Securities Act) is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions"[40] and

2007 15, 21 (2007).

35. Landis, *supra* note 22, at 34-35.

36. *See id.* at 35; *see infra* note 58 and accompanying text.

37. *See* MARY BRIGNANO & J. TOMLINSON FORT, REED SMITH: A LAW FIRM CELEBRATES 125 YEARS 91 (2002) (citing comments of Ralph Demmler, the first Republican Chairman of the SEC appointed by President Eisenhower, who attributes influential input into the legislative process to Congressman Sam Rayburn who considered himself the father of the Securities Act).

See also Landis, *supra* note 22, at 40 (recounting how John Foster Dulles led a group of New York lawyers to Congress to attack the legislation as "undermin[ing] our financial system"). Rayburn, according to Landis, "exhibited considerable annoyance at these accusations" and "insisted that all that was being demanded was that the system should live up to its pretensions." *Id.*

38. *See* GORDON, *supra* note 23, at 334.

39. *Id.* at 336. But as to new issues of securities, as one economist has noted, their market "ground to a virtual standstill in the early 1930s, recovering slowly by the close of the decade." Simon, *supra* note 27, at 298.

40. SEC v. Ralston Purina Co, 346 U.S. 119, 124 (1953).

Some see the current Supreme Court as unduly favorable to business interests at the expense of consumers and investors. *See, e.g.*, Jeffrey Rosen, *Supreme Court, Inc.: How the* "[t]he registration requirements are the heart of the Act."[41] The SEC has expanded on this logic by stating that the Securities Act "has two basic objectives: (1) require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities."[42] Commentator Jeffrey Mann restates that objective with some punch, "The goal, of course, is to apply the disinfectant of sunlight to the black box of corporate management; the presumption is that issuers exposed to public scrutiny will not be able to exploit investor ignorance to their advantage."[43]

The Commission goes on to say "[a] primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities."[44] This emphasis on the prevention of investor fraud has led one commentator to observe that the SEC has not historically been concerned with systematic risks which he defines as economic shock brought on by substantial volatility in asset prices.[45] These systemic risks are more appropriately, he argues, the concerns of other regulators like the

Nation's Highest Court Became Increasingly Receptive to the Arguments of American Business, N.Y. TIMES SUNDAY MAG., Mar. 16, 2008 at 38. Yet in its recent session the High Court has again strongly endorsed the concept that business must operate under the rule of law with this remark, "a dynamic, free economy presupposes a high degree of integrity in all its parts, an integrity that must be underwritten by rules enforceable in fair, independent, accessible courts." Stoneridge Inv. Partners, LLC v. Scientific Atl., Inc., 128 S. Ct. 761, 770 (2008).

41. Pinter v. Dahl, 486 U.S. 622, 638 (1988).

42. U.S. Securities and Exchange Commission, *supra* note 28, at 16.

43. Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 475 (2007) (discussing the actions corporate agents will take to circumvent information regulation and their costs).
The author there echoes Justice Brandeis's classic comment, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Fredrick A. Stokes Company 1914).

44. U.S. Securities and Exchange Commission, *supra* note 28, at 16.
The Commission's comments evoke the preamble to the Securities Act which states: "An Act to provide 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, and for other purposes." Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§77a-77aa (2007)). On this point, see also C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 598-602 (1996) (amplifying the Commission's assertions about the benefits of registration). Bradford's article states that the information provided in a registration might better enable investors to evaluate the returns that their securities will generate and therefore provide a more accurate price for the stock. The article also says that such an accurate price brought about by registration may reduce the riskiness of a security. It cites several studies that dispute or corroborate those findings but finds them inconclusive. *Id.*

45. *See* Troy A. Parades, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 990 (2006).

Federal Reserve and the Treasury.[46]

Yet the Commission defines its mission as three-fold: not just "to protect investors," but also to "maintain fair, orderly, and efficient markets, and facilitate capital formation."[47] Supporting those objectives are remarks that were included in the official description of the statute at the time of its enactment. They state that the Act was also designed to foster the broader goals of our economy by bolstering public confidence in business and directing financing to its most productive uses.[48] Additionally, as one distinguished authority has noted, "[T]here is little question that disclosure has a substantial impact on the normative conduct of corporations. In this regard, the Commission's disclosure policies . . . have played a positive role in influencing the establishment of improved standards of conduct."[49]

B. The Process of Registration

Section 5(c) of the Securities Act of 1933 prohibits the offer of securities by federal jurisdictional means without first filing a registration statement for them with the SEC.[50] Correspondingly, Section 5(a)(1) of the

46. *Id*. In the same article, however, Professor Parades (now SEC Commissioner) states that governmental intervention in the market "also serves the larger goal of promoting capital formation and more efficient and liquid securities markets in that investor protection regulation can shore up investor confidence in the integrity of the securities markets." *Id.* at 1005

47. U.S. Securities and Exchange Commission, *supra* note 28, at 1.
The Commission repeats that assertion by stating in a recent report that one of its four strategic goals is to "promote healthy capital markets." U.S. SECURITIES AND EXCHANGE COMMISSION, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 24 (2007); *see also* Marcel Kahan, *Securities Law and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L. J. 977, 979 (1992) (quoting one commentator who has crisply put this objective: "one principal goal of securities laws: [is] to create stock markets in which the market price of a stock corresponds to its fundamental value").

48. *See* S. REP. NO. 73-47 (1933) ("[The Act is] to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of a prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.").

49. MARC I. STEINBERG, CORPORATE INTERNAL AFFAIRS: A CORPORATE AND SECURITIES LAW PERSPECTIVE 29 (1983).
The notion that securities registration would promote a new public policy toward business, one that would lead it to operate more for the common good, was also part of the vision of the New Deal. As Supreme Court Justice William O. Douglas, an early staffer and later chairman of the SEC wrote of the Securities Act, "[i]t is symbolic of a shift of political power. That shift is from the bankers to the masses; from the promoter to the investor. It means the government is taking the side of the helpless, the suckers, the underdogs." William O. Douglas, *Protect the Investor*, 23 YALE L. REV. 521, 522 (1934).

50. 15 U.S.C. § 77e(c) (2006); *see also* Section 2(a)(3) of the Securities Act, 15 U.S.C. §77b(a)(3) (2006) (defining "offer" broadly as including "every attempt or offer to dispose

Act prohibits the sale of securities unless the registration statement has become effective.[51] Violation of these provisions is not only a crime,[52] but also gives one who purchases these securities a right to rescind the transaction.[53] The contents of a registration statement are prescribed by the Act. It must contain a prospectus providing specific items of factual information to investors.[54] The Commission has promulgated specific regulations which govern those disclosures and forms which the issuer must employ in this process.[55]

The completion of a successful registration is a rather complicated matter requiring the skills of attorneys, accountants, investment bankers and the active cooperation of the issuer's officials.[56] The prospectus must contain all the information called for by the Commission's regulations and forms.[57] Such disclosure, however, is necessary but not sufficient because the anti-fraud provisions of the Act compel the revelation of all facts that an investor would consider important in making a decision to purchase the

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of, or solicitation of an offer to buy, a security or interest in a security, for value").

51. 15 U.S.C. § 77e(a)(1) (2006).

52. Section 24 of the Securities Act, 15 U.S.C. § 77x (2006).

53. Section 12(a)(1) of the Securities Act, 15 U.S.C. § 77l(a)(1); *see also* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 207 (4th ed. 2007) (explaining that Section 12(a)(1) is designed to "give teeth" to the registration requirement).

54. Section 10 of the Securities Act, 15 U.S.C. § 77j (2006); *see also* Section 2(a)(10) of the Securities Act, 15 U.S.C §77b(a)(10) (2006) (defining prospectus broadly as, among other things, any writing "which offers any security for sale or confirms").

55. *See* Section 7(b)(1) of the Securities Act, 15 U.S.C. § 77g(b)(1) (empowering the SEC to prescribe further information for a registration statement); Section 10(c) of the Securities Act, 15 U.S.C.§ 77j(c) (giving the Commission such power in regard to the prospectus). For such regulations, see, e.g., Regulation S-K, 17 C.F.R. § 229 (2006), Regulation S-X, 17 C.F.R. § 210 (2006), and Regulation C, 17 C.F.R. § 230 (2007). For registration forms, see, e.g., 17 C.F.R. §§ 239.0-1-239.65 (2008).

56. *See* Bradford, *supra* note 44, at 602-08 (listing these direct costs of registration: (1) the direct expenses of preparing, filing and distributing the required disclosure documents, (2) the commissions and fees paid to underwriters and others selling the securities, (3) the delay associated with registration, (4) the costs of maintaining the government registration system, and (5) other miscellaneous costs associated with registration, and also discussing certain other costs of registration that he says are less direct and more difficult to quantify such as having to make public disclosure about one's business and subjecting the company to filing periodic and other reports with the SEC required by the Securities Exchange Act of 1934). *See generally* Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1 (1981) (covering the practice and procedure of selling securities to the public for the first time).

57. *See supra*, note 55 and accompanying text; *see also* U.S. Securities and Exchange Commission, *Registration under the Securities Act of 1933*, http://www.sec.gov/answers/regis33.htm (last visited July 10, 2008) (summarizing the essential facts that a prospectus must contain in these four categories: (1) A description of the company's properties and business; (2) A description of the security to be offered for sale; (3) Information about the management of the company; and (4) Financial statements certified by independent accounts).

securities.[58] In the end, all this activity is directed toward the preparation of a document that will satisfy the SEC's staff, who may review it and must typically accelerate its effective date before the issuer may sell the securities.[59]

In addition, when an issuer is "in registration" great care must be taken to ensure that the company complies with the provisions of the Act that govern what conduct it may undertake to market the securities during various periods of this process. Those subsections of Section 5, which are supplemented by extensive SEC rules,[60] are geared toward making sure that investors get their primary information about the offering from the

58. *See* Sections 24 and 32 of the Exchange Act, 15 U.S.C. §§ 77x, 78ff (2006) (making violators of the anti-fraud provisions of Section 17 of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, subject to civil penalties); Section 11 of the Securities Act, 15 U.S.C. § 77k (2006) (setting forth a detailed scheme listing those defendants who may be liable to purchasers for any material misstatements or omissions in an effective registration statement, and also enumerating certain affirmative defenses which those individuals may maintain, most importantly the "due diligence" defense); Section 15 of the Securities Act, 15 U.S.C. § 77o (2006) (providing that a person who controls a person liable under Section 11 or 12 shall be jointly and severally liable with that controlled person, unless such controlling person did not have knowledge of the facts or reasonable grounds to believe in the existence of such facts upon which the controlled person's liability is predicated); Section 12(a)(2) of the Securities Act, 15 U.S.C. §77l(a)(2) (imposing civil liability on any person who offers or sells securities by means of a written or oral communication containing material misstatements or omissions); Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (holding that similar to Section 11 liability, the remedy under § 77l(a)(2) is limited to purchasers of securities in public offerings); Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (allowing certain individuals to avoid liability under § 77k if they can show that they meet a specific standard of knowledge or conduct with respect to the material misstatements or omissions).
Courts have also long recognized an implied right of action for securities fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) (2008) and 17 C.F.R. § 240.10b-5 (2008). It exists despite the express remedies of Sections 11 and 12 of the Securities Act and is not limited to securities sold in a public offering. *See* Herman & MacLean v. Huddleston, 459 U.S. 375 (1983).

59. *See* Section 8 of the Securities Act, 15 U.S.C. § 77h (providing that a registration statement will become effective 20 days after it is filed or earlier if the SEC accelerates the effective date). In practice issuers always seek acceleration by the Commission and, for that cooperation, the SEC may seek to have the issuer make changes in its registration statement as provided in Securities Act Rule 461. 17 C.F.R. § 230.461 (2007). *See also* HAZEN, *supra* note 27, at 125-32 (providing more information regarding the SEC review process).

60. For purpose of the application of Section 5, the registration process is generally divided into three time-frames: (1) the pre-filing period (the time before the registration statement is filed), (2) the waiting period (the time between filing and the registration statement becoming effective), and (3) the post-effective period. Generally Section 5(c) prohibits offers during the pre-filing period and Section 5(a)(1) prohibits sales until the post-effective period. Section 5(b)(1) restricts the use of prospectuses during the waiting period.
The Commission's rules made to augment these statutory prohibitions are complex and not easy to summarize. For a good general discussion, see HAZEN, *supra* note 27, at 73-103. In 2005, the Commission liberalized this process. *See infra* notes 70-73 and accompanying text.

registration statement, which is presumed to be accurate because its disclosure is made under penalty of criminal and civil liability.[61]

C. *Reforms by the SEC to Facilitate Registration*

Ever since the deregulatory movement began in the late 1970s, the Commission has been sensitive to the charge that registration is unduly costly and burdensome on issuers, inhibiting the formation of capital and even discouraging entrepreneurship.[62] The SEC's first significant reform in this area was to integrate the disclosure requirements under the Securities Act with those of its companion legislation, the Securities Exchange Act of 1934 (Exchange Act).[63] While the former statute, as has been discussed,[64] requires registration of securities before they are offered and sold to the public, the latter imposes a regime of continuous disclosure once those companies become public.[65]

That system of dual disclosure was not only duplicative, the Commission found, but much information was already available about publicly-traded firms and embedded in the price of their stock.[66] So, since 1982, the SEC has allowed companies that are already making periodic and

61. *See supra* note 58 and accompanying text.

62. *See* Roberta A. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 700 (2008) (explaining that the SEC's answer to this criticism has been to expand the exemptions to registration rather than making it "more user-friendly and less likely to result in after-the-fact lawsuits").

63. *See* Adoption of Integrated Disclosure System, Exchange Act Release No. 6383, 47 Fed. Reg. 11,380 (Mar. 16, 1982).

64. *See supra* notes 50-51 and accompanying text.

65. *See* U.S. Securities and Exchange Commission, *supra* note 28 at 17-18 ("The [Exchange] Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities. Companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. These reports are available to the public through the SEC's EDGAR database.").
These periodic reports are required by Section 13(a) of the Exchange Act. 15 U.S.C. § 78m(a) (2006). They include the annual report on Form 10-K required by Exchange Act Rule 13a-1, 17 C.F.R. § 240.13a-1 (2008), the quarterly report on Form 10-Q required by Exchange Act Rule 13a-13, 17 C.F.R. § 240.13a-13 (2008), and current reports on Form 8-K required by Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11 (2006).

66. Professor Homer Kripke, a frequent critic of the SEC, restated the results of this efficient market hypothesis as it related to stock prices. *See* Homer Kripke, *Fifty Years of Securities Regulation in Search of a Purpose*, 21 SAN DIEGO L. REV. 257, 273 (1984) ("The economists concluded that for most investors the best program is to assume that market prices reflect all available information, the market is fair, and market prices are the best evidence of value.").
As other commentators have noted, however, "[s]mall firms not subject to the SEC's mandatory corporate disclosure system seem to have been responsible for a majority of fraud cases brought by the Commission." LOSS & SELIGMAN, *supra* note 21, at 36. Accordingly, issuers of securities that are not subject to the Exchange Act's periodic disclosure requirements must do full blown registration statements when selling securities.

other reports under the Exchange Act to either use them as the bases of their prospectuses when doing another registered offering, or in certain cases just presume that such information is already at hand for interested investors. Over the years the Commission has sought to refine that approach.[67]

The SEC has also promulgated registration forms with relaxed disclosure burdens for small businesses seeking to raise a limited amount of capital from the public.[68] In addition, the Commission has allowed issuers to register securities and "put them on the shelf" for sale at a later time when market conditions may be more favorable.[69] This not only can help issuers maximize their investment revenue, but can also allow them to avoid costly delays when they want to make securities sales to the public.

In 2005, furthermore, the SEC promulgated new rules significantly liberalizing the offering activities that are permitted to certain companies during the period they are "in registration."[70] In doing so, the Commission created several categories of issuers based on their reporting status under the Exchange Act and their capitalization and trading activity in the public markets. The two largest of these, the "seasoned issuer"[71] and the "well-known seasoned issuer" (WKSIs),[72] are allowed the most latitude in offering activity during the registration process. For instance, there are no restrictions on the statements or solicitation activities of well-known seasoned issuers during the entire registration process.[73]

67. *See* HAZEN, *supra* note 27, at 117-18.

68. *See* Forms SB-1 and SB-2; *see also* STEINBERG, *supra* note 53, at 131-32 (providing standards for the use of these forms).

69. Securities Act Rule 415, 17 C.F.R. § 230.415 (2008); Shelf Registration, Securities Act Release No. 6499, Fed. Reg. 52,889 (Nov. 23, 1983).

70. Securities Offering Reform, Securities Act Release No. 8591, 70 Fed. Reg. 44,722, 44,725-27 (Aug. 3, 2005).

71. *Id.* at 44,730 (defining seasoned issuers as companies that are required to file reports under the Exchange Act and are eligible to use either registration Form F-3 or S-3 but do not qualify as WKSIs, meaning that the issuer has at least $75 million of outstanding securities held by non-affiliates or has a certain minimum investment grade rating on its debt securities).

72. Securities Act Rule 405, 17 C.F.R. § 230.405 (2008) (defining WKSIs as companies that have been reporting companies under the Exchange Act for at least one year, that are timely in their Exchange Act filings, and that either: (1) have a worldwide market value of all their common equity held by non-affiliates of at least $700 million, or (2) have issued in the past three years at least an aggregate principal amount of nonconvertible securities other than common equity of $1 billion).

73. Securities Act Rule 163, 17 C.F.R. § 230.163 (2005); *see also* Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989) (calling for such reform as it might pertain to the pre-filing period before their passage). *But see* Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005,* 56 CATH. U. L. REV. 561 (2007) (arguing trenchantly that the Commission has gone too far with those reforms and is neglecting its mission of protecting investors).

IV. QUESTIONING THE VALIDITY OF REGISTRATION

A. *The Arguments to Abolish Registration*

Despite its widespread acceptance as a cornerstone of New Deal reforms, business interests have never liked registration or any federal regulation of securities. Ralph H. Demmler, appointed as the first Republican Chairman of the SEC by President Eisenhower, recalls that Ike told him that "he (President Eisenhower) did not know much about the Securities and Exchange Commission but that some of his friends in New York thought the whole bunch of securities laws should be repealed."[74] Demmler says he advised the president "that no such repeal would be possible or desirable," and Ike agreed.[75]

More pointed attacks on registration and the whole regime of securities disclosure, however, have come from the academy. Beginning in the 1960s Professors Stigler,[76] Bentson,[77] and Manne[78] presented empirical evidence which they claimed indicated that the federal securities laws did not enhance investor value. Their results, however, were widely criticized for reaching an incorrect conclusion because they examined the wrong variables.[79] In further repudiation, an Advisory Committee on Corporate Disclosure set up by the SEC to investigate the findings of those studies concluded "that the disclosure system established by Congress . . . is sound and does not need radical reform or renovation."[80]

Academic criticism of mandated corporate disclosure has continued nonetheless, much of it apparently motivated by distaste for government

74. BRIGNANO & FORT, *supra* note 37, at 89.

75. *Id.*

76. George Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721 (1964).

77. George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973).

78. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). *But see* Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1439 (1967) ("Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market and intracorporate relationships that satisfy such noneconomic goals as fairness, just rewards and integrity.").

79. *See* Frank B. Cross & Robert A. Prentice, *Economies, Capital Markets, and Securities Laws* 33 (University of Texas School of Law, Law and Economics Research Paper No. 73, 2006) (citing a number of studies to that effect which also established the positive results for investors arising from the disclosure mandated by the federal securities laws); Simon, *supra* note 27, at 313 (finding that, after the passage of the Securities Act, "uniform regulation lowered new-issues risk, and in some cases, increased expected returns")

80. H. COMM. ON INTERSTATE & FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMMISSION ON CORPORATE DISCLOSURE TO THE SEC 95-29 (Comm. Print 1977).

regulation[81] and a credulous attitude about the all-encompassing benefits of the free-market.[82] As a leading author has noted, a lot of that has "an unreal quality."[83] Many of those anti-regulatory approaches begin, appropriately enough, with the common-sense assumption that corporate managers who are entrusted with other people's money will have an obvious temptation to enrich themselves in various ways at the expense of their public shareholders.[84] Yet these conservative theorists go on to assert that this inherent conflict can be overcome by non-governmental forces.[85]

For instance, these theorists assert that reputational concerns will require that corporate officials deal honestly with their stockholders.[86]

81. *See* Edward L. Glaeser, *Psychology and the Market*, 94 AM. ECON. REV. 408, 412 (2004) ("[T]he case for laissez-faire is based more on the fallibility of the state than on the perfection of markets."). In this area, the law and economics school is prominent. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

82. *See* Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 777 (2006) (discussing alternatives to a strong SEC such as a regulatory competition model).

83. LOSS & SELIGMAN, *supra* note 21, at 32; *see also* E.J. DIONNE, JR., STAND UP FIGHT BACK 112 (2004) ("[C]apitalism cannot work without regulation, which is simply a fancy word for rules and laws. Powerful people will often take advantage of their muscle unless someone—like it or not, that someone usually works for the government—keeps an eye on them.").

84. Scholars more favorable to government regulation also emphasize this point, of course. For capital markets to provide the type of financing that a thriving economy needs, investors must be willing to turn their funds over to others to manage for them. *See* Cross & Prentice, *supra* note 79, at 7 ("The basic economic problem is how to control the investment risk so that investors will be willing to risk their funds. Solving or ameliorating this problem is of enormous social value. Absent a solution, many investors will choose not to play the game at all, while others will discount the securities they purchase to take into account the increased risk of loss.").

85. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (stating that the separation of ownership from control in a large public corporation explains "why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports").

86. *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (reflecting a viewpoint that investors should be able to price privately-supplied investor protections including those against fraud). *But see* Cross & Prentice, *supra* note 79, at 5 ("His unfortunate timing in publishing this proposal just as Andy Fastow, Bernie Ebbers, Ken Lay, Jeff Skilling, Jack Grubman, Henry Blodgett, Richard Scrushy, Dennis Kozlowski, Mark Swartz, Richard Causey and so many others decided to forfeit their reputations in exchange for short-term lucre, does not necessarily mean that it might not be resurrected when memories fade."); Diana B. Henriques and Zachery Kouwe, *Top Trader is Accused of Defrauding Clients*, N.Y. TIMES, Dec. 12, 2008 at B1, B5 (suggesting that specific infamy must go to Bernard Madoff who admitted in the last weeks of 2008 that his money management firm was "all just one big lie" and "basically a giant ponzi scheme"). Total losses suffered by Madoff's blue-chip clientele may amount to fifty billion dollars. Diana B. Henriques and Alex Berenson, *The 17th Floor; Where*

Furthermore, competition for capital will compel firms to furnish potential purchasers of their securities with all of the relevant information they desire.[87] Correspondingly, conservative theorists claim that contractual mechanisms can guarantee the veracity and sufficiency of this voluntary disclosure.[88] By such private arrangements, structural devices, such as auditing,[89] can also be set up to monitor management's behavior and incentives, such as stock options plans, can be created to better align management and shareholder interests.[90]

Wealth Went to Vanish, N.Y. TIMES, Dec. 15, 2008 at A1.

87. *See* Easterbrook & Fischel, *supra* note 81, at 681-85, 715 (making the case for "self-induced" disclosure but ultimately taking a rather diffident approach to the arguments that would repeal our system of mandatory disclosure by stating that "[w]e cannot say that the existing securities laws are beneficial, but we also are not confident that their probable replacements would be better"); *see also* Kripke *supra* note 66, at 270-71 (noting that a wide-spread system of informal corporate disclosure exists outside the Commission's mandatory regime). While Professor Kripke was a long time advocate for the proposition that securities regulation was unnecessary, the author heard Professor Kripke at UCLA law school in 1978 admitting that, based on his own observations, the quality of corporate disclosure and the honesty of the securities markets have been greatly improved by the Securities Act. *See also* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387 (2001) (arguing that quality companies will want to "signal" their quality through voluntary disclosures).

88. *See* Edward Glaeser, Simon Johnson & Andrei Schleifer, *Coase Versus the Coasians*, 116 Q. J. ECON. 853, 853 (2001) ("[T]he buyers and issuers of securities have available to them a vast range of private arrangements to achieve efficiency, including contracts such as corporate charters, certification by intermediaries, and various forms of bonding [that] . . . render most laws and regulations unnecessary."). *But see* Cross & Prentice, *supra* note 79, at 22 (indicating that while such provisions seemingly protect investors, they may be susceptible to various judicial interpretations and ultimately require monitoring of management's performance; as such, they are not a substitute for the standardized disclosure and enforcement rules that are a central benefit of securities regulation).

89. Some of this protection, it is argued, can be provided by not only auditors but also other third party monitors, such as analysts, or rating agencies. Unfortunately, many of these "watchdogs" have proven to be anything but zealous in their oversight activities on behalf of shareholders. Laxity and lack of integrity by outside accountants, as epitomized by the Enron scandal, have famously sparked the Sarbanes-Oxley legislation. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C) which established a Public Company Accounting Oversight Board to monitor the actions of auditors. It also promulgated stricter standards for auditor independence, enhanced financial disclosure requirements, and stiffened penalties for white collar crimes. *See* Joris M. Hogan, *The Enron Legacy: Corporate Governance Requirements for a New Era*, 31 SEC. REG. L.J. 142 (2003) (outlining the circumstances surrounding the enactment of the Sarbanes-Oxley Act of 2002); *see also supra* note 6 and accompanying text (describing the blatant corruption of analysts and rating agencies).

90. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990 at 138. *See also* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973 (2008) (highlighting recent scandals involving the

In addition, critics of mandatory registration often point to criminal penalties and civil liability provisions for those who make material misrepresentations and omissions in the offering or sale of securities.[91] While such laws can certainly be used to punish and deter fraudsters and provide remedies for their victims, such *ex post* solutions afford no up-front protection to investors who have already been induced to part with their money on the basis of inaccurate or incomplete information.[92] Since those funds are often squandered or frittered away by unscrupulous promoters, such measures may amount to merely closing the barn door after the horses have left.[93]

B. The Arguments to Abolish Registration are not Convincing

While these voluntary, contractual, and reputational approaches may have some benefit to investors, they fall considerably short of guaranteeing that investors will receive the full and uniform disclosure that registration mandates.[94] Even if full disclosure is required for an issuer to sell its securities for the optimum price, firms may still decide not to reveal information if they believe that such information will be advantageous to their competitors[95] or embarrassing to management.[96]

backdating of stock options).

91. *See supra* note 58 and accompanying text (outlining penalties and liabilities pursuant to federal securities laws). *But see* Easterbrook & Fishel, *supra* note 81, at 677-79 (indicating that while a legal regime without such fraud protection is theoretically possible, even jurists from the law and economic school see it as beneficial). *See generally* Abry Partners V, L.P. v. F & W Acquisitions LLC, 891 A.2d 1032 (2006) (deciding against interpreting a stock purchase agreement to totally disallow claims for intentional fraud on public policy grounds).

92. Joseph A. Franco, *Why Antifraud Prohibitions are not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223 (2002).

93. *See, e.g.*, Ianthe Jeanne Dugan, *The Rabbi, the Do-Gooder, the Lost $100 Million*, WALL ST. J., Aug. 15, 2008 at C1 (providing an unfortunately typical example of a massive fraud upon investors primarily from the Orthodox Jewish community revealed in August 2008, when money was raised without SEC registration through approximately 60 “private placements”); *see also* Ian Urbina, *A Palm Beach Enclave, Stunned by an Inside Job*, N.Y. TIMES, Dec. 15, 2008 (stating that “[t]he Madoff scandal also appears to have involved significant affinity fraud among Jewish-Americans”).

94. An appropriate analogy here is to the uniform system of weights and measures that nations adopt to standardize their commerce. If each merchant could set her own definition for a “pound” or a “gram,” trading would be made bewilderingly complex. *See* Ralph K Winter, *On ‘Protecting the Ordinary Investor,’* 63 WASH. L. REV. 881, 891 (1988) (warning against the costly alternative of having disclosure requirements imposed by various states).

95. *See* LOSS & SELIGMAN, *supra* note 21, at 37.

96. *See* Item 402 of Regulation S-K, 17 C.F.R. § 229.402 (2008) (requiring extensive disclosure of management’s related party transactions with the issuer and of management’s compensation packages).

On top of that, there may be substantial reasons in some cases for corporate officials to be less than honest with their investors, at least in the short run. Such situations would obviously occur when management's compensation or even its survival would depend on suppressing bad news.[97] Even when corporate officials have no actual intent to deceive, they may have a tendency to put the firm's results in the best light or to hope unfavorable results will be temporary and thus not need to be disclosed.[98]

In short, the realities of "human greed and short-sightedness,"[99] so much in evidence during the contemporary economic turmoil, refute these deregulatory theories. Rather, they confirm the abiding need for strict, mandatory measures to protect investors and present a cogent case for the revitalization of securities registration.

V. THE EXEMPTIONS FROM REGISTRATION

A. The Exemptions in General

Not every offering of securities must be registered with the SEC. Certain classes are deemed "exempt securities" in Section 3[100] of the Act, and certain specific transactions are freed from the registration mandate by Section 4.[101] The Commission summarizes the most important of these exemptions in four categories: (1) private offerings to a limited number of persons or institutions; (2) offerings of limited size; (3) intrastate offerings; and (4) securities of municipal, state, and federal governments.[102] It then goes on to state, "[b]y exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering

97. H.R. REP. NO. 95-29, *supra* note 80; *see also* Roger Lowenstein, *The Benign Corporate Oligarchy*, N.Y. TIMES, SUNDAY MAGAZINE, Dec. 12, 2004, at 54 (describing the continuing tendency of corporate executives to manipulate their accounting figures by citing a study by Campbell Harvey, a professor at Duke University, finding "that a remarkable 78% of 302 chief financial officers said they would take some action to 'smooth' quarterly earnings and meet expectations, even if that action sacrificed long-term value").

98. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harm)*, 146 U. PA. L. REV. 101 (1997).

99. Prentice, *supra* note 82, at 778; *see also* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004) (supporting the SEC's mandatory disclosure system).

100. 15 U.S.C. § 77c (2004).

101. 15 U.S.C. § 77d (1980).

102. U.S. Securities and Exchange Commission, *supra* note 57, at 1.

the costs of offering securities to the public."[103]

B. The Non-Public Exemption Geared toward "Sophisticated" Investors

Many exempt offerings, however, are not small, either in the dollar amounts they raise or in the number of investors they involve. The exemption for transactions "not involving any public offering,"[104] the so-called private placements of securities, literally contains no limits on its applicability, and in *Ralston Purina*, the Supreme Court refused to impose any such limits.[105] Rather, the Court said the exemption exists for those who can "fend for themselves,"[106] i.e., those who do not need the disclosure compelled by a registration statement to make "informed investment decisions."[107]

One commentator states that this "sophisticated offeree exemption" is designed for those with "sophistication, bargaining power, or access to information about the issuer, [who] do not need the protection that registration provides."[108] This interpretation corresponds to some rather terse legislative history on the provision stating that the exemption is intended for situations "where there is no practical need for (the Act's) application (or) where the public benefits are too remote."[109]

Early case law after *Ralston Purina* interpreted the exemption narrowly, making it virtually inapplicable to offerings made to non-institutional investors who were not top officials of the issuer.[110] In response, the Commission used its rulemaking authority to create an administrative "safe harbor,"[111] Rule 146,[112] which more clearly and expansively defined a nonpublic offering.[113]

In general, Rule 146 provided that such offerings would qualify for

103. *Id*.

104. Section 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (1980).

105. *Ralston Purina*, 346 U.S. at 125-26.

106. *Id*. at 125.

107. *Id*. at 124.

108. Bradford, *supra* note 44, at 622-23.

109. H.R. REP. NO. 73-85, at 5 (1933).

110. *See, e.g.*, Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); SEC v. Continental Tobacco Co., 463 F.2d 137, 158 (5th Cir. 1972) (limiting the registration exemption after *Ralston Purina*).

111. *See* Section 19(a) of the Securities Act, 15 U.S.C. §77s(a) (2002) (empowering the Commission to prescribe rules and regulations to carry out provisions of the Act and makes good faith compliance with those administration pronouncements a defense to any civil liability imposed by the Act).

112. Securities Act Rule 146, 17 C.F.R. § 230.146 (repealed 47 Fed. Reg. 11,261 (1982)).

113. Notice of Adoption of Rule 146 Under the Securities Act of 1933—"Transactions by an Issuer Deemed Not to Involve and Public Offering," Securities Act Release No. 33-5487, 4 S.E.C. Docket, 1974 WL 161966 (April 23, 1974).

the exemption if the issuer reasonably believed that the securities were not purchased by more than 35 persons (excluding purchasers of more than $150,000).[114] In addition, every offeree would have to be either financially sophisticated or have the ability to bear investment risks and obtain the advice of a financial expert.[115] Each offeree also would have to be furnished with information comparable to what she would get in a registration statement.[116] Investors so qualified would then, according to the Commission, satisfy the *Ralston Purina* criteria that private placement offerees be able to "fend for themselves."[117]

Even after the exemption for non-public offerings was broadened by Rule 146, criticism continued that its criteria were still overly technical and unduly burdensome to small business.[118] Congress, responding to the small business lobby, then added Section 4(6) to the Act in 1980[119] to prod the SEC into further liberalizing the private placement exemption.[120] It freed offerings under $5 million from registration if they were made only to "accredited investors." Congress defined "accredited investors" to include certain financial institutions and other persons that the SEC might so designate "on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."[121]

Taking its cue from that legislation, as well as the deregulatory fervor of the Reagan administration, in 1982, the Commission replaced Rule 146 with Rule 506 of Regulation D, a new and expanded safe-harbor provision designed to cover not only private placements but also other exemptions for

114. Securities Act Rule 146(g), 17 C.F.R. § 230.146(g) (repealed 47 Fed. Reg. 11,261 (1982)).

115. Securities Act Rule 146(d), 17 C.F.R. § 230.146(d) (repealed 47 Fed. Reg. 11,261 (1982)).

116. Securities Act Rule 146(e), 17 C.F.R. § 230.146(e) (repealed 47 Fed. Reg. 11,261 (1982)).

117. Securities Act Release No. 33-5487, *supra* note 113, at 3. Furthermore, to guarantee the non-public nature of the offering, there could be no general advertising or widespread solicitation of investors. Securities Act Rule 146(c), 17 C.F.R. § 230.146(c) (repealed 47 Fed. Reg. 11,261 (1982)). There would also have to be limits on quick re-sales of the securities. Securities Act Rule 146(h), 17 C.F.R. § 230 146(h) (repealed 47 Fed. Reg. 11,261 (1982)).

118. *See* Rutheford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1143, 1168-69 (1977); H. David Heumann, *Is SEC Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings?*, 55 NEB. L. REV. 1, 9 (1975); Ellsworth A. Weinberg & Michael W. McManus, *The Private Placement Exemption Under the Securities and Exchange Act of 1933 Revisited, and Rule 146*, 27 BAYLOR L. REV. 201 (1975) (criticizing the criteria for the exemption of non-public offerings).

119. Section 4(6) of the Securities Act, 15 U.S.C. § 77d(6) (1980).

120. Karmel, *supra* note 62, at 688.

121. Section 2(a)(15)(ii) of the Securities Act, 15 U.S.C. § 77b(a)(15)(ii) (2000).

small and limited offerings.[122]

C. *Enter the Accredited Investor*

Regulation D's major innovation was the "accredited investor," a category of securities purchasers who would automatically meet the *Ralston Purina* criteria of being able to fend for themselves (i.e. they would not need the disclosure compelled in a registration statement). According to former SEC Commission Robert Karmel, this new concept has created a "huge exemption[] from [the SEC's] regulatory scheme"[123] and helped create "an enormous private placement market."[124] Included in the definition of that term are not only certain institutional investors[125] and insiders of the issuer,[126] but also individuals with net worths of at least $1 million[127] or annual incomes of at least $200,000 in each of the two most recent years with expectations of reaching that level in the current year.[128]

Under Rule 506, then, the SEC allows an unlimited amount of money to be raised from any number of accredited investors who do not need to be supplied with any documentary disclosure. For non-accredited investors, however, certain restrictions remain. There can be no more than thirty-five of them,[129] they have to be supplied with registration-like written information,[130] and they or their advisors have to be financially sophisticated.[131] In another change from 146, Rule 506 places no limits on the suitability of potential purchasers (offerees). Advertising and general solicitation, however, are still deemed incompatible with the "non-public" nature of the exemption.[132] Along those lines restrictions are also still kept

122. Regulation D, Securities Act Rules 501-06, Revision of Certain Exemptions for Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389 (March 8, 1982) (codified as amended at 17 C.F.R §§ 230.501 to 506 (2008)); *see also* Leonhardt, *supra* note 4, at 32 ("For three decades now, the American economy has been in what historian Sean Wilentz calls the Age of Reagan. The government has deregulated industries, open the economy more to market forces and above all, cut income taxes.").

123. Karmel, *supra* note 62, at 681.

124. *Id.* at 682.

125. Securities Act Rule 501(a)(1)-(3), (7-8), 17 C.F.R. § 230.502(a)(1)-(3), (7-8).

126. Securities Act Rule 501(a)(4), 17 C.F.R. § 230.502(a)(4).

127. Securities Act Rule 501(a)(5), 17 C.F.R. § 230.502(a)(5). That total can include assets of both spouses. *Id.*

128. Securities Act Rule 501(a)(6), 17 C.F.R. § 230.501(a)(6). For joint income of spouses that figure must be at least $300,000. *Id.*

129. Securities Act Rule 506(b)(2)(i), 17 C.F.R. § 230.506(b)(2)(i).

130. Securities Act Rule 502(b), 17 C.F.R. § 230.502(b).

131. Securities Act Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii).

132. Securities Act Rule 502(c), 17 C.F.R. § 230.502(c). *But see infra* notes 225-27 and accompanying text (stating that the SEC's proposed changes to Regulation D would loosen that requirement for "large accredited investors").

on quick re-sales of the securities and the issuer must demonstrate that it has taken reasonable care to guard against them.[133]

Registration is therefore unnecessary, according to the Commission's Regulation D reasoning, if an investor has a certain amount of personal wealth. These wealthy individuals, regardless of their business acumen, are automatically considered able to "fend for themselves" when it comes to decisions about securities. Some questioned, however, whether that is actually the case[134] and correspondingly whether the Commission had gone beyond its statutory authority in promulgating Regulation D.

Ralston Purina interpreted the § 4(2) exemption as requiring that both offerees and purchasers be among "the particular class of persons . . . [who do not] need the protection of the Act."[135] Rule 506 however, with its focus solely on purchasers of the securities, dispenses with the need for any inquiry into the suitability of those to whom the investment is offered. *Ralston Purina* also held that the exemption was designed for those who "have access to the same kind of information that the act would make available in the form of a registration statement."[136] Yet Rule 506 has no requirement that accredited investors have such data available to them.

Along those lines, case law following *Ralston Purina* held that for the private placement exemption to be satisfied, all investors would have to have access to the type of information that registration would provide.[137] Yet the actual situation did not follow that wealthy individuals would necessarily have such investment data. Even if they did, there was no assurance that they on their own would have the sophistication to appropriately analyze the information.[138] Put starkly, through Regulation D the SEC seemed to be abandoning attempts to safeguard from fraud investors with a certain amount of personal assets.[139]

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133. 17 C.F.R. § 230.502(d). *But see infra* notes 162-74 and accompanying text for a discussion on the resale market for private placement securities.

134. *See infra* note 138-39 and accompanying text.

135. *Ralston Purina Co*., 346 U.S. at 125.

136. *Id.* at 125-26.

137. *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 903 (5th Cir. 1977); Lawler v. Gilliam, 569 F.2d 1283, 1289 (4th Cir. 1978).

138. As one contemporary observer remarked of Regulation D., "the reforms adopted by the SEC . . . may overestimate the abilities of the presumably wealthy. . . . Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment. Consequently, they frequently fail to seek professional advice . . . ." Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984).

139. *Compare id.* (stating ruefully, "[i]t is important to note that the categories of 'wealthy' investors frequently include the widows and orphans whose protection traditionally has been the sacred trust of the SEC") *with* Jason Zweig, *How Bernie Madoff Made Smart Folks Look Dumb*, WALL ST. J., Dec. 13-14, 2008, at B1 (asserting that "[t]he Madoff fraud appears to have involved a large number of wealthy individuals and many

D. Limited Civil Liability to Deter Fraud in the Sale of 506 Securities

In addition, those who purchase securities sold in unregistered offerings have weaker remedies if they are defrauded than those who buy securities in registered issuances. Section 11 of the Securities Act provides a direct cause of action for materially false or misleading statements in an effective registration statement.[140] On the other hand, private placees who are cheated in their investments must rely on the implied right of action that Courts have recognized under Rule 10b-5 of the Exchange Act.[141] Rule 10b-5 is much more exacting in its requirements for recovery than Section 11 and therefore provides less a deterrent to fraud.

Section 11 was designed to guarantee that, to the greatest extent possible, purchasers of registered securities would be afforded full disclosure of all aspects of their investment.[142] Under Section 11, defrauded investors may bring direct federal claims against all officers of the issuer who sign the registration statement,[143] all of the company's directors,[144] its underwriters,[145] and its accountants.[146] Those defendants can only escape liability if they can show that they were not negligent in the preparation of the registration statement, which in most cases requires that they prove that after a reasonable investigation they had no knowledge of any falsehoods or material omissions in the document.[147]

Liability under 10b-5 on the other hand, is restricted to those who have actually made the material falsehoods or omitted to state the material facts to purchasers or sellers of the securities.[148] Moreover, to escape

investors who should have been sophisticated enough to be skeptical of a fund that purported to return 12% consistently over a number of years").

With the evidence of wide-spread investment fraud on the elderly, such concerns are even more pressing today. *See infra* notes 233-36 and accompanying text.

140. *See supra* note 58 and accompanying text.

141. *Id.*

This jurisprudence has been re-enforced since the Supreme Court interpreted another express cause of action for fraud in the Securities Act, § 12(a)(2), requiring that the securities under this type of action be sold in a public offering. *See* Gustafson v. Alloyd Co., 513 U.S. 561 (1995); *see also supra* note 58 and accompanying text.

142. STEINBERG, *supra* note 68, at 188.

143. Section 11(a)(1), 15 U.S.C. § 77k(a)(1).

Section 6 of the Securities Act, 15 U.S.C. § 77f(a), lists those who must sign the registration statement which include the issuer, the issuer's principal executive, financial and accounting officers and a majority of the issuer's board of directors or persons performing similar functions.

144. Section 11(a)(2), 15 U.S.C. § 77k(a)(2).

145. Section 11(a)(5), 15 U.S.C. § 77k(a)(5).

146. Section 11(a)(4), 15 U.S.C. § 77k(a)(4).

147. Section 11(b)(3), 15 U.S.C. § 77k(b)(3); *see also* Escott v. Barchris Constr. Corp. 283 F. Supp. 643 (S.D.N.Y. 1968) (issuing findings of fact in a § 77k case).

148. *See* Central Bank, N.A. v. First Interstate Bank, N.A., 551 U.S. 164 (1994)

liability in a Section 11 claim, defendants must show "due diligence" in the preparation of the registration statement.[149] In a 10b-5 action, however, plaintiffs have the burden of not just proving but also pleading with particularity of facts[150] that the defendants acted with "scienter"; that is, something more than mere negligence.[151] Plaintiffs must also plead with particularity of facts to show that they relied on statements or omissions by the defendants that were materially false or misleading.[152]

E. No State Registration for 506 Securities

Furthermore, protection for investors in private placements has also been lessened by legislation which preempts state registration. When Congress passed the Securities Act in 1933, it left state regulation of securities intact.[153] States accordingly continued with their own requirements for the registration of securities sold to their citizens along with exemptions to that process, which in many instances mirrored the federal ones.[154] In 1996, however, Congress passed the National Securities Markets Improvement Act (NSMIA)[155] that pre-empted the power of states to require registration of "covered securities."[156] Those included, among

(discussing the requirements for liability under 10b-5).

149. *See supra* note 147 and accompanying text.

150. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

151. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (discussing the scienter standard).

152. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008) ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action").

A presumption of investor reliance may be drawn when one with a duty of disclosure omits a material fact. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972). Likewise, reliance can be shown under the fraud-on-the-market doctrine, which presumes that a false or misleading statement has skewed the price of the security. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). *But see* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005) (holding that a plaintiff cannot establish that defendants' misstatements caused her economic loss merely by establishing and showing that the price of the stock was inflated on the date of purchase because of the misrepresentations).

153. The federal securities laws, when enacted in the 1930s, were viewed as a supplement to existing state laws rather than a substitute for them. Richard H. Walker, *Evaluating the Preemption Evidence: Have the Proponents Met Their Burden?*, 60 LAW & CONTEMPT. PROBS. 237, 237 (1997).

Both the Securities Act and the Exchange Act contain express provisions preserving state law rights and remedies, Section 16 of the Securities Act, 15 U.S.C. § 77p, Section 28 of the Exchange Act, 15 U.S.C. § 78bb.

154. The North American Securities Administrators Association promulgated a Uniform Limited Offering Exemption in 1983 that was intended to coordinate with Regulation D and to be the same among the states. Securities Act Release No. 33-6561 (Dec. 6, 1984).

155. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

156. Section 18(a)(1) of the Securities Act, 15 U.S.C. § 77r(a)(1).

others, securities traded on a national securities exchange[157] as well as those exempt from registration by SEC rules promulgated under Section 4(2), such as Rule 506.[158]

The dual system of securities regulation left in place by Congress in 1933 Act had long been criticized as being duplicative, unnecessarily expensive, and time-consuming.[159] State regulators however operated for the most part on a separate premise than the SEC, one where the "merits" of the offering, not merely disclosure of its details, would determine whether a particular offering could go forward.[160] This had the added benefit of assuring a second line of protection for investors, one that saw to it they would be treated fairly.[161]

F. An Unregulated Trading Market in Private Placement Securities

In addition, the Commission also appeared to be giving up its role in making sure that the capital markets were supplied with accurate information in the resale of private placement securities. The Securities Act requires that, absent an exemption, there must first be an effective registration statement for the sale of every security.[162] Section 4(1) of the Act,[163] however, exempts the overwhelming number of secondary sales where there is no public offering occurring.[164]

Securities Act Rule 144[165] defines when such is the case. As to securities taken in a private placement, it now provides generally that they

157. Section 18(b)(1)(A), 15 U.S.C. § 77r(b)(1)(A).

158. Section 18(b)(4)(D), 15 U.S.C. § 77r(b)(4)(D).

159. Conference Report on National Securities Markets Improvement Act of 1996, H.R. REP. NO. 104-864 (1996), Fed. Sec. L. Rep. (CCH) ¶ 85,847 at 88, 650 (1996).

160. Revised Uniform Securities Act § 304.

161. See HAZEN, *supra* note 27, at 321, who comments, "[s]tate law merit regulation imposes a substantive scrutiny that goes further than the full disclosure approach of the federal laws."

Even after NISMA, leading courts have held that mere purported compliance with Rule 506 will not be sufficient to preempt state registration. Issuers must therefore fully comply with the requirements of the Rule 506 to be exempt from state registration. Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 912 (6th Cir. 2007); Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723, 727-30 (Minn. 2008), Blue Flame Energy Corp. v. Ohio Dep't of Commerce, 871 N.E.2d 1227, 1243-44 (Ohio Ct. App. 2006); Buist v. Time Domain Corp. 926 So. 2d 290, 297 (Ala. 2005). *Contra* Temple v. Gorman, 201 F. Supp. 2d 1238, 1243-44 (S.D. Fla. 2002).

162. Section 5(a)(1), 15 U.S.C. § 77e(a)(1).

163. Section 4(1), 15 U.S.C. § 77d(1).

164. As Professor Steinberg puts it, "[T]he Section 4(1) exemption permits individual investors to resell their securities without registration, provided such resales are viewed as 'transactions' (rather than part of a 'distribution') and such persons are not deemed underwriters." STEINBERG, *supra* note 68, at 159.

165. 17 C.F.R. § 230.144.

For a good general discussion of Rule 144, see STEINBERG, *supra* note 68, at 169-78.

may be freely sold after a holding period of just six months—if they are investments in a company which files Exchange Act reports[166]—and after a holding period of just one year in any event.[167] Unregistered securities sold in a private placement may now be resold to anyone just one year after they have been initially purchased.

The SEC expanded this approach in 1990, when it adopted Rule 144A[168] to allow the unregistered resale of private placement securities to "qualified institutional buyers" (QIBs). These buyers are generally companies who own more than $100 million of non-affiliated securities.[169] If they are banks or savings and loan associations, they must have a net worth of at least $25 million.[170] The net worth qualifications are also substantially reduced in certain situations for securities dealers.[171]

This exemption has been used most often for the sale of securities by foreign companies in the U.S. capital markets.[172] When they are sold to QIBs like pension and mutual funds, which are ultimately composed of ordinary investors, little real disclosure may be made of the operations of those off-shore entities.[173] Nor do they have to become Exchange Act reporting companies even though the funds of a large number of American citizens may be indirectly committed to them.[174]

VI. THE RISE OF HEDGE FUNDS

A. *Unregulated Investment Pools*

Much of the worrisome, contemporary turbulence in our capital markets can be attributed to the startling growth of large unregulated investment pools. They include private equity funds—a more genteel name

166. Rule 144(d)(1)(i), 17 C.F.R. § 230.144(d)(1)(i).

167. Rule 144(d)(1)(ii), 17 C.F.R. § 230.144(d)(1)(ii).

168. Resale of Restricted Securities, Securities Act Release No. 33-6862, Fed. Sec. L. Rep. (CCH) at 17,933 (Apr. 30, 1990).

169. Securities Act Rule 144A(a)(1)(i), 17 C.F.R. § 230.144A(a)(1)(i).

170. Securities Act Rule 144A(a)(1)(vi), 17 C.F.R. § 230.144A(a)(1)(vi).

171. Securities Act Rule 144A(a)(1)(ii-iii), 17 C.F.R. § 230.144A(a)(1)(ii-iii).

172. STEINBERG, *supra* note 68, at 182.

173. Congressional critics were alert to this possible prejudice to small savers at the inception of the rule. See excerpts of a letter from Congressmen John D. Dingell and Edward J. Markey to SEC Chairman David Breeden in Robert A. Barron, *Control and Restricted Securities: Some Comments on SEC Rule 144A*, 18 SEC. REG. L. J. 400 (1990).

174. Commissioner Karmel also observes that the market for 144A offerings has grown enormously during the nearly two decades of its existence, exceeding in 2006 the total capital raised on the New York and American Stock Exchanges and the NASDAQ combined. *See* Karmel, *supra* note 62, at 684-85, 689.

For a prescient early perspective on how Rule 144A would promote an institutional resale market, see Kellye Y. Testy, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 IND. L.J. 233 (1990).

for groups that were called corporate raiders in the 1980s.[175] Their goal is to buy up businesses from stockholders so that the private equity funds can restructure and resell the businesses in different forms.[176] The most prominent in this category are hedge funds, a term that former SEC Chairman William Donaldson said was the "catch-all classification for many unregistered privately managed pools of capital." [177]

Hedge funds have shaken up the market using aggressive trading strategies such as selling stocks short, buying complex derivative securities, or using complicated and proprietary mathematical formulas.[178] Misgivings about the deleterious impact that they could have on the overall economy first surfaced in 1998 with the Long Term Capital Growth fiasco. There, Federal Reserve Chairman Alan Greenspan and others had to intervene to make sure the collapse of that fund would not imperil the entire financial system.[179]

Such concerns have only grown in recent times as billions of dollars have flowed into these unregulated funds. During the past fifteen years the number of hedge funds has increased from about five hundred to perhaps ten thousand.[180] In 2006, they accounted for about half of the trading on the New York and London Stock Exchanges, and controlled about $2

175. *See* Daniel J. Morrissey, *Safeguarding the Public Interest In Leveraged Buyouts*, 69 OR. L. REV. 47, 73-82 (1990) (explaining the questionable impact that private equity funds may have on communities and the economy in general).

176. According to one source, this constitutes an "unprecedented wave of deal making." Dennis K. Berman et al., *As Deal Barriers Fall, Takeover Bids Multiply*, WALL ST. J., May 8, 2007, at A1.

177. Jessica Natali, *Trimming the Hedges is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations*, 15 U. MIAMI BUS. L. REV. 113, 116 (2006).

In the same vein, one author called hedge funds "private and largely unregulated investment pools for the rich." ROGER LOWENSTEIN, WHEN GENIUS FAILED 24 (2000).

The name "hedge fund" is at least partially derived from the financial flexibility that these entities have to diversify their investment strategies. Unlike mutual funds, which are substantially regulated under the Investment Company Act, hedge funds can sell short and highly leverage themselves, as well as employ any one of approximately thirteen investment strategies. Gerald T. Lins, Thomas P. Lemke, Kathryn L. Hoenig & Patricia Schoor Rube, *Hedge Funds and Other Private Funds: Regulation and Compliance* § 1.1 (2004); *see also* U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (2003), at 34-36 (discussing a variety of hedge fund investment strategies).

Another commentator noted the following as hedge funds' most salient characteristics: "privately organized, professionally administered, and not widely available to the public." Sue Ann Mota, *Hedge Funds: Their Advisers Do Not Have to Register with the SEC, but More Information and Other Alternatives are Recommended*, 67 LA. L. REV. 55, 55 (2006).

178. Karen Blumenthal, *Grande Expectations: A Year in the Life of Starbucks' Stock* 3,109 (Crown Business 2007).

179. *See* Michael Lewis, *How the Eggheads Cracked*, N.Y. TIMES MAG. Jan. 24, 1999, at 24; *see also* LOWENSTEIN, *supra* note 177.

180. John Cassidy, *Hedge Clipping*, THE NEW YORKER, July 2, 2007, at 28.

trillion in assets.[181] Managers of three hedge funds that year earned more than $1 billion.[182]

B. The Unregulated Nature of Hedge Funds

Unlike banks, brokerage firms, and publicly-held companies, hedge funds are largely unregulated and their operations are not open to public scrutiny.[183] Principally, Regulation D's definition of an "accredited investor" makes it possible for these firms to sell their unregistered securities not just to institutions, but to individuals as well, so long as the securities meet the net worth or annual income provisions of the Regulation.[184] In addition, hedge funds do not have to register or file periodic reports under the Exchange Act so long as they keep the number

181. David Cho, *Hedge Funds Mystify Markets, Regulations*, WASH. POST, July 4, 2007, at A1.

182. "In the jargon of Wall Street, hedge funds seek 'alpha' returns," in part by borrowing heavily. Managers charge their clients fees that can amount to 33% of the gains. Cassidy, *supra* note 180, at 28. They structure their compensation arrangement so their income is only taxed at the capital gains rate of 15% instead of at the ordinary income rate of 35%. *See* David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, N.Y. TIMES, July 13, 2007, at A1; Paul Krugman, Op-Ed. & Paul Krugman, *An Unjustified Privilege*, N.Y. TIMES, July 13, 2007, at A19.

As such aggregation of capital has proliferated both in number and resources, those firms have correspondingly enjoyed access to the privileged information that power brings. It appears, therefore, that their above-average returns may have more to do with the misuse of inside information than to investing acumen. Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1.

As to the difficulty of prosecutors uncovering such illegal activity, the remarks of one fictional government law enforcement officials may be on point:

> We get better, they get better. Especially with these new hedge funds and private-equity firms, we have no idea what's going on. If you're cautious at all, we're not going to catch you. You'd have to be pathetic amateurs, like Bacanovic and Martha Stewart. The big Wall Street guys, forget about it. Most of them don't even think insider trading is a crime. In some countries, it isn't.

DOUG STUMPF, CONFESSIONS OF A WALL STREET SHOESHINE BOY 109 (Harper Collins 2007).

183. *See generally*, Sargon Daniel, *Hedge Fund Registration: Yesterday's Regulatory Schemes For Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247 (2007).

As to their secrecy, one expert has said "[h]edge funds go to great lengths to maintain their mystique . . . managers rarely grant interviews and the mostly young analysts and traders who make up the funds' staff sign confidentiality agreements barring them from discussing their work." Cassidy, *supra* note 180, at 28.

Because of their secrecy, they have been described as "the mysterious rich uncle of the investment industry family; no one agrees on his age, occupation or history, but everyone knows he is related." Joseph Hellrung, *Hedge Fund Regulation: Investors are Knocking at the Door, but Can the SEC Clean House Before Everyone Rushes in?*, 9 N.C. BANKING INST. 317, 319 (2005).

184. *See supra* note 127 and accompanying text.

of their equity holders under 500.[185]

One would think, however, that hedge funds would come under the strict regulatory and disclosure requirements of the Investment Company Act of 1940 which, by its terms, covers any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[186] If such were the case those companies would be prohibited from undertaking the "excessively risky"[187] strategies usually entailed by leveraging. In addition, their operational flexibility would be severely restricted because the Investment Company Act requires that a majority of such company's shareholders consent to any of those changes.[188]

Yet hedge funds are able to escape from such strictures by meeting one of two exemptions to the Act's applicability, both of which are premised on the company not making, or planning to make, a registered public offering. One allows exclusion if the firm's securities are also held by less than 100 beneficial owners.[189] The other covers companies whose securities are held by "qualified purchasers"; generally speaking those who have put at least $5 million into the firm or hold no less than $25 million in investments.[190]

The avoidance of registration under the Securities Act therefore makes it possible, in large part, for hedge funds to avoid coming under the regulatory safeguards that should most fittingly apply to them as companies that deal in the securities of other firms.[191] It also conveniently frees their

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The legal form which the typical hedge fund takes has been described in this fashion: "To date, hedge funds have regularly been structured as limited partnerships or limited liability companies (LLCs), with fund investors being limited partners or LLC members, respectively, who acquire their interests in the fund in private placements that are exempt from the registration requirements of the federal securities laws." Parades, *supra* note 45, at 982.

185. Section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g) (2006). Accordingly, hedge funds typically limit their equity holders to a maximum of 499. Daniel, *supra* note 183, at 260.

186. Investment Company Act, 15 U.S.C. § 80a-3(a)(1)(A) (2004). As Commissioner Karmel aptly puts it, "[f]unctionally, a hedge fund or private equity fund is no different from a mutual fund in that all three vehicles are pooled investment funds managed by an investment adviser." Karmel, *supra* note 62, at 691.

187. Daniel, *supra* note 183, at 264.

188. Investment Company Act, § 80a-13(a)(1) (2004).

189. Investment Company Act, § 80a-3(c)(1) (2004).
As Daniel notes, "[i]f a beneficial owner owns less than 10% of the issuer's securities and is an investment company under Section 3(c)(1) or 3(c)(7), then the beneficial owner will be treated as a single owner of the shares in the fund. Importantly, the exception in Section 3(c)(1) reflected Congress's view that private investment companies with limited investors do not require registration." Daniel, *supra* note 183, at 262.

190. Investment Company Act, § 80a-3(c)(7)(A) (2004).

191. Not all commentators would agree with that characterization, ass one has written on the standard structure of hedge funds that avoids SEC regulation, "[t]his is not to suggest

managers to charge exorbitant fees usually taken in a percentage of the return[192] which is generally unavailable in registered investment companies.[193]

C. *The SEC's Attempt to Regulate Hedge Funds*

The SEC, in a 2003 report,[194] listed a number of troubling issues involving the exponential growth of hedge funds that it believed could be cured by greater regulatory oversight. As restated by one observer, those concerns fell into two broad categories: "(i) the Commission's lack of knowledge and inability to regulate or investigate the funds and (ii) the Commission's inability to protect less sophisticated investors who buy into the funds not fully aware of the danger of default from the risks of hedge funds (both market and fraud)."[195]

Most importantly, the Commission wanted information about the operation of hedge funds which was not available in any public source. It also wanted to deter fraud by holding hedge fund managers subject to examination by the Commission's staff. Additionally, the SEC was troubled by what it called the "retail effect," meaning the impact that the funds would have on ordinary investors through their aggregation of resources from pension funds, university endowments, and other institutional investors.[196]

Acting on those concerns the Commission, by a 3-2 vote, modified Rule 203(b)(3)-2 of the Investment Advisers Act of 1940[197] to require hedge fund managers to register under its provisions. Under that provision, advisers with fewer than 15 clients are exempt from that mandate. The Commission's modified rule would have "looked through" institutional entities that invested in hedge funds to see each of their members as a client. In that regard, the SEC's action differentiated hedge funds from other pooled investment vehicles such as private equity companies and

that hedge funds skirt SEC regulation as a result of shenanigans where hedge fund managers strain to fit their funds within obscure legal loopholes. Rather the design of federal securities laws itself has caused hedge funds to be lightly regulated." Paredes, *supra* note 45, at 976.

192. *See supra* note 182 and accompanying text.

193. For an adviser to receive a performance fee in a registered investment company, investors must have a net worth of $1.5 million or at least $750,000 under management by the adviser. Investment Company Rule 205-3, 17 C.F.R. § 275.205-3 (2006).

194. Securities and Exchange Commission, *supra* note 177.

195. Daniel, *supra* note 183, at 268.

196. Those are a distillation of factors cited by Paul F. Roye, Director of the SEC's Division of Investment Management, for the Commission desire to take regulatory action over hedge funds. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Exchange Act, 69 Fed. Reg. 45172 (proposed July 28, 2004).

197. 17 C.F.R. § 275.203(b)(3)-2(a).

venture capital groups where the Commission did not deem its "look through" approach to be necessary.[198]

The U.S. Court of Appeals for the District of Columbia, however, struck down the rule.[199] It found that, although the general partners of hedge funds would meet the definition of "investment adviser" in the Act, they could still qualify for the fewer-than-fifteen-client exemption. The Court held that the Commission, with its "look through" provision, had acted contrary to the legislative intent that investing entities, not their shareholders or members, were the advisers' clients.[200] The SEC chose not to appeal this decision.[201]

D. Fall-out from the Sub-Prime Crisis

The financial crisis resulting from the sub-prime lending meltdown has revealed just how precarious many hedge funds were. In recent years bankers became increasingly adept at "slicing and dicing" their loans and selling them off to participating investors all over the world. Subprime loans, in many ways, were the piece de resistance of that effort.[202] A number of hedge funds borrowed heavily to stock their portfolios with those complex derivative securities that were collateralized by shaky mortgages. They also invested in other poorly-secured debt obligations.[203]

The ensuing debacle has claimed the prominent investment bank, Bear Stearns[204] and has resulted in billions of dollars in losses for hedge funds

198. The Commission's primary reason for that differentiation was that private equity and venture capital funds tend to make longer term investments. It therefore made its "look through" rules applicable to funds where owners are permitted to redeem any portion of their interests within two years of purchase. *See* Daniel, *supra* note 183, at 270-71.

199. Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

200. *Id.* at 879.

201. The Commission however proposed a new rule that would, among other things, prohibit all advisers of pooled investments from defrauding investors by means of false or misleading statements. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Exchange Act Release No. 33-8766, IA -2576, File No. 27-25-06 (Dec. 27, 2006); *see also infra* note 209-15 and accompanying text.

202. Tett, *supra* note 5.

203. *See* Floyd Norris, *Market Shock: AAA Rating May Be Junk*, N.Y. TIMES, July 20, 2007, at C1 (discussing how securities that were backed by sub-prime mortgages were given inflated credit ratings and then sold to hedge funds run by Bear Stearns).

204. *See supra* note 4 and accompanying text.

These problems first came to public light in June, 2007 when Bear Stearns had to come up with $3.2 billion in loans to bail out two of its hedge funds that had speculated heavily in such collateralized debt obligations. Kate Kelly & Serena Ng, *Bear Stearns Bails Out Fund with Big Loan*, WALL ST. J., June 23, 2007, at A1.

and the banks that loaned them funds to leverage their risky strategies.[205] The result is a virtual collapse of "financial faith," at least in western circles.[206] As one noted financial commentator put it, "if we have learned anything from this unrelenting credit mess, it is that greater disclosure is needed if investors are to regain their trust in the financial system."[207]

VII. THE SEC'S PROPOSED REVISIONS TO REGULATION D

A. *One Bright Spot for Investor Protection in Hedge Funds*

In the midst of this financial meltdown, the SEC surprisingly has proposed amendments to Regulation D that, for the most part, would further weaken the registration requirement.[208] In one segment of those suggested changes, however, the Commission has shown admirable concerns for ordinary investors, particularly as to their special need for protection within investment vehicles such as hedge funds.[209] In its release, the SEC noted the unique risks of those capital pools, particularly with regard to conflicts of interest, fee structures, and investment strategies.[210]

Toward this end, the Commission reissued a renewed request for comment on its earlier proposal[211] to create a new category of "accredited natural persons" who would be the only individuals allowed to invest in those funds.[212] This new category would require that purchases of those securities not only meet the current net worth or income standard for individual accredited investors[213] but also that those accredited investors have at least $2.5 million in "investments," a term which, like its earlier use in the proposal defining "large accredited investors," would exclude real estate held for personal use.[214]

The SEC's initial proposal was met with a spate of negative comments because it sought to curtail investor access to these unregistered investment

205. Cassel Bryan et al., *Peloton Flew High, Fell Fast: Winning Hedge Fund Lost on Bets as Credit Crunch Moved at Breakneck Speed*, WALL ST. J., May 12, 2008, at C1; *see also supra* notes 4-5 and accompanying text.

206. Tett, *supra*, note 5.

207. Gretchen Morgenson, *A Bond Market, Starved for Sunshine*, N.Y. TIMES, Aug. 17, 2008, at BU1.

208. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 17 C.F.R. §§ 200, 230, and 239 (August 3, 2007).

209. *Id.* at 47-49.

210. *Id.* at 48.

211. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 33-8766, 17 C.F.R. §§ 230 and 275 (Dec. 27, 2006).

212. SEC Release No. 33-8828, *supra* note 208, at 48.

213. *See supra* notes 127-28 and accompany text.

214. SEC Release No. 33-8828, *supra* note 208, at 48.

pools.[215] Despite such criticism, the SEC is wisely attempting to provide some protection to individuals of limited means by restricting their access to these volatile, unregistered funds.

B. *A Generally Ill-Advised Initiative*

For the most part, however, the SEC's proposed changes are not in line with its mission to protect investors and safeguard the integrity of our capital markets. The Commission presents these amendments as a further attempt to assist small business in its capital formation,[216] but the SEC's real reasons may be more strategic.

As Commissioner Karmel has suggested, the Commission is perhaps giving ground again on registration's coverage to preserve its "jurisdictional grip and ideological purity with respect to the regulation of initial public offerings."[217] In other words, to forestall the outright repeal of the registration requirement by deregulatory zealots, the Commission seems to be trying to appease them by allowing its mini-death by a thousand cuts.

For whatever reason, the SEC's initiative here is wrong-headed. Not only is it in derogation of the Commission's mission to protect investors from fraud when studies show that such harmful activity is more rampant than ever,[218] it would also lessen the disclosure needed by the capital market when current events have demonstrated that just the opposite approach is called for.[219]

C. *The Proposed Changes*

The Commission's release puts forth three major amendments to Regulation D for consideration. Most significantly it would create another alternative category of accredited investors that would consist of individuals with as little as $750,000 in "investment owned funds."[220] Unlike the current Rule 501(a)(5) and (6) definitions of accredited investors that are based respectively on a person's net worth and income,[221] this alternative test would not include real estate held for personal purposes.[222]

Yet with the substantial increase in stock value over the years, many

215. *Id.* at 49.
216. *Id.* at 5.
217. Karmel, *supra* note 62, at 681.
218. *See infra* notes 233-35 and accompany text.
219. *See supra* note 207 and accompanying text.
220. SEC Release No. 33-8828, *supra* note 208, at 29-31.
221. *See supra* notes 127-28 and accompanying text.
222. SEC Release No. 33-8828, *supra* note 208, at 34-35.

mature individuals are now holding such accumulation of assets. This is particularly a result of the decline of defined benefit pension plans and the tax law's concomitant encouragement to workers to develop their own retirement funds.[223] By that fact alone, however, those individuals can hardly be deemed sophisticated enough to protect their financial interests on their own. On the contrary, without registration, they can easily fall prey to the blandishments of unscrupulous promoters and smooth con men, as the SEC has long feared.[224]

In addition, the SEC is proposing to define a new class of "large accredited investors" that would generally consist of individuals with more than $2.5 million in total assets or annual incomes in excess of $400,000.[225] Securities salesmen could make pitches to this new class of investors in unregistered offerings through advertising or general solicitations. Such techniques, however, seem obviously incompatible with the exemption for "non-public" offerings.[226] Therefore, the Commission has traditionally forbidden these techniques out of an appropriate concern that a wide range of investors in those situations might be lured into unsafe or unduly speculative ventures.[227]

The SEC has also announced that it is considering relaxing its "integration" doctrine that prohibits issuers of unregistered securities from making such offerings in serial fashion to finance the same business.[228] The Commission has historically believed that condoning such activity would artificially divide one total money-raising venture and thus abuse the carefully considered exemptions from registration.[229]

The SEC's proposal, however, would shorten the current safe harbor

223. The most popular of these tax deferred arrangements is Section 401(k) of the Internal Revenue Code, I.R.C. § 401(k) (2008).

224. *See* Sec. and Exch. Comm'n, Investor Advocacy and Education, http://www.sec.gov/investor.shtml (last visited Aug. 20, 2008) (listing the SEC's extensive publications warning investors of investment schemes); *see also* Pres Release, Sec. and Exch. Comm'n, SEC to Convene Summit to Combat Investment Fraud Against Senior Citizens Securities Exchange Commission, Release No. 2007-160 (Aug. 7, 2007) *available at* http://www.sec.gov/news/press/2007/2007-160.htm (announcing the SEC's second annual senior summit to protect older Americans from investment fraud).

225. SEC Release No. 33-8828, *supra* note 208, at 9-17.

226. Section 4(2) of the Securities Act, 15 U.S.C. § 77d(2).

227. Regulation D, Securities Act Rule 502(c), Rules Governing the limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, (codified as amended at 17 C.F.R. § 230.502(c)).

228. SEC Release No. 33-8828, *supra* note 208, at 57-61.

229. Securities Act Release No. 33-4522 (1962). For the author's views on integration, *see* Daniel J. Morrissey, *Integration of Securities Offerings—The ABA's "Indiscreet" Proposal*, 26 ARIZ. L. REV. 41 (1984). Further strengthening this doctrine, the Minnesota Supreme Court has recently affirmed that two unregistered offerings may be integrated even when there are no sales in the second one. Risdall v. Brown-Wilbert, 753 N.W.2d 723, 731-34 (2008).

that allows such offerings if they are spaced at least six months apart and permit them if they are made just 90 days from each other.[230] A leading state administrator, however, has wisely commented that such a change is "unwarranted and dangerous"[231] for a number of reasons aptly summed up by his view that "90 days will not be an adequate period to make a series of exempt offerings . . . truly separate and distinct from each other."[232]

D. Regulation D and Investor Fraud

The Commission's proposal to allow unregistered offerings to those with just $750,000 of investment income is in stark derogation of the SEC's own findings about the pervasive nature of "elder fraud." On its website, the Commission states that 5 million senior citizens--an astounding number--are victims of such practices every year.[233] A study by the NASD sought to understand why older consumers with "nest-eggs" of accumulated assets are frequently easy prey for these schemes.[234] The study found that those persons have often recently experienced negative events in their lives and are susceptible to the cunning of criminals who capitalize on the senior citizens' psychological profiles.[235]

A letter of comment to the SEC well encapsulated the dangers of the Commission's proposed expansion of its exemptions to the registration requirements, particularly as they apply to older investors. The author identified himself as a law student and wrote to the Commission, "Your proposed (as well as current) definition would include my 90 year old grandmother as an accredited investor (believe me she has no expertise in this field) as well as a whole host of the elderly."[236] He also mentioned a relative of his who is currently a major league baseball player who "doesn't know the first thing about finance, yet he'd meet the SEC's proposed definition of not only accredited, but large accredited investor."[237]

The dangers to ordinary investors here from unregistered offerings made to accredited investors have also been made worse by inflation.

230. SEC Release No. 33-8828, *supra* at 57-61.

231. Letter from Bryan J. Lantagne, Director, Massachusetts Securities Division to the Securities and Exchange Commission (Oct. 12, 2007) at p. 8 (commenting on Release Nos. 33-8828 and IC-27922).

232. *Id.*

233. *See* Securities and Exchange Commission, Investor Advocacy and Education, http://www.sec.gov/investor.shtml (last visited Aug. 20, 2008).

234. NASD Investor Education Foundation, *Investor Fraud Study Final Report* (May 12, 2006).

235. *Id.* at 5.

236. Letter from David J. Lazarovic to the Securities and Exchange Commission (Aug. 17, 2007).

237. *Id*.

Professor Marc Steinberg found that someone who qualified as an accredited investor in 2000 by virtue of having a net worth of $1 million[238] would only have had net assets of $600,000 in 1982 and thus would not have met the wealth test that Regulation D contemplated at its inception. Likewise, someone who so qualified because of $200,000 annual income[239] in 2000 would only have had $120,000 in earnings in 1982, also failing to satisfy the accredited investor standard for income as it was originally set.[240]

In addition, a big rise in the percentage of accredited investors may also be a result of the substantial appreciation in housing valuations during the last 25 years, because that figure can be included in an individual's net worth under Rule 501(5).[241] Reflecting those factors, the Commission proposal acknowledges that in 1982, when Regulation D was adopted, only 1.87% of U.S. households qualified for accredited investor status, compared with 8.47% today.[242] Yet the SEC has there indicated it will not consider adjusting the net worth or annual income qualifications for accredited investor status until 2012, and even then it will only use 2006 as its baseline.[243]

VIII. CONCLUSION

In the depths of this country's worst economic crisis, lawmakers found a way to save a financial system that offered promise as well as peril. They accomplished this by requiring that those who seek other peoples' money by offering the possibility of profit be fully honest about the risks as well as the potential rewards of those ventures. The mechanism for this mandated disclosure is the registration statement, a tool that has underwritten the integrity of our capital markets for three-quarters of a century.

This registration requirement should not be weakened, but rather made more forceful in its application. Investor protection demands this and the recent gyrations of our financial system have shown the misfortune that can befall capital markets when there is no governmental apparatus to guarantee full and forthright disclosure to potential investors. As this Article has discussed, the SEC has constantly been sensitive to reviewing the required content of registration statements to make them "user-friendly." At the same time, it has reformed its regulations governing

238. Securities Act Rule 501(5), 17 C.F.R. § 230.501(5).

239. Securities Act Rule 501(6), 17 C.F.R. § 230.501(6).

240. Marc Steinberg, *The "Accredited" Individual Purchaser Under Regulation D: Time to Up the Ante*, 20 SEC. REG. L.J. 93 (2001).

241. *See* Marc Steinberg, *Letter to Securities and Exchange Commission*, File No. 27-18-07, at 2.

242. SEC Release No. 33-8828, *supra* note 208, at 15.

243. *Id.* at 42-43.

issuers' conduct in the registration process to make sure that they do not unreasonably inhibit capital formation.

However, with the adoption of Regulation D 25 years ago, the Commission began whittling away at the viability of the registration statement by expanding the exemptions to its applicability. The SEC's current proposals to widen them even further are particularly ill-considered in light of the crisis of confidence that the hedge fund/sub-prime debacle has brought to our financial system. If our economy is to thrive, the registration requirement must maintain its vigor. Only then, with the legitimate hope of a fair return, will investors have the confidence to furnish capital to needy enterprises.