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The Role of the States in the Regulation of Private Placements

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Introduction

The Jumpstart Our Business Startups Act[2] (JOBS Act), signed into law by the President on April 5, 2012[3] after passage by Congress with bipartisan support, was ostensibly designed to promote job creation by eliminating perceived securities regulatory impediments to capital formation by small businesses.[4] After all, the prevailing argument was that small businesses are the engine for job development in our economy[5] and, particularly in a presidential election year, high unemployment is a problem that has to be addressed through deregulation.[6] In the end, with scant attention to the detail that only a tiny subset

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1 H. Edward Harter Chair of Commercial Law, Louis D. Brandeis School of Law, University of Louisville. The author thanks Thomas A. Rutledge, Carolyn Duncan, and Thomas P. Borg for their helpful comments, as well as Professor Rutheford B Campbell, Professor James D. Cox, and the other participants at the Kentucky Law Journal's symposium, *The Securities Act of 1933 at 80: Does It Provide Fair and Efficient Access to Capital?*, held at the University of Kentucky College of Law on October 11, 2013. The author also gratefully acknowledges the contributions of his administrative assistant, Janet Gribbins Sullivan, in the final preparation of this Article.

2 Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

3 Barack Obama, U.S. President, Remarks at the JOBS Act Bill Signing (Apr. 5, 2012), (transcript *available at* http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing). President Barack Obama observed at the time he signed the JOBS Act that "because we're still recovering from one of the worst recessions in our history, the last few years have been pretty tough on entrepreneurs." *Id.* The President stated, "[o]ur job is to help our companies grow and hire. That's why I pushed for this bill." *Id.* He expressed his especial support for the JOBS Act crowdfunding provisions:

> Right now, you can only turn to a limited group of investors – including banks and wealthy individuals – to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it's time our laws did as well. Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors – namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.
>
> Of course, to make sure Americans don't get taken advantage of, the websites where folks will go to fund all these start-ups and small businesses will be subject to rigorous oversight.

Id.

4 *See* Press Release, House Comm. on Fin. Servs., H.R. 2940, the Access to Capital for Job Creators Act (Oct. 7, 2011), *available at* http://financialservices.house.gov/blog/?postid=263515.

5 *See, e.g.*, 158 Cong. Rec. S1690 (daily ed. Mar. 15, 2012) (statement of Sen. Thune).

6 *See generally America's Capital Markets: A Muffled Big Bang*, Economist, Mar. 31, 2012, *available at* http://www.economist.com/node/21551483. According to one financial journalist, "Congress seems to have been moved . . . by the appealing title—at a time of high unemployment,

of small businesses actually create jobs,[7] Congress passed a deregulatory statute applicable for the most part to all businesses, large and small, from Facebook[8] and large hedge funds to college students creating iPhone applications in their proverbial garages. The JOBS Act's primary provisions include authorization for crowdfunding,[9] higher shareholder thresholds before companies become subject to periodic reporting requirements,[10] significant relief from regulatory and disclosure requirements in registered public offerings for "emerging growth companies,"[11] a tenfold increase in amounts that can be raised in Regulation

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no one wants to vote against an act with 'jobs' in the title, even if it is actually short for 'Jumpstart Our Business Start-ups Act.'" *Id.*

7 Congress failed to note that of the 27 million small businesses in the United States, less than one-fourth have any employees and a much smaller percentage ever grow beyond twenty employees. Aaron Chatterji, *Why Washington Has It Wrong on Small Business*, WALL ST. J. (Nov. 12, 2012), http://online.wsj.com/news/articles/SB10001424052702303768104577460040429463650 . The vast majority of jobs created come from *new* startups (mostly between one and five years old), a handful of which grow into global enterprises. Ned Smith, *Small Business Startups Create the Most New Jobs*, BUSINESSNEWSDAILY (Aug. 31, 2010, 11:55 PM), http://www.businessnewsdaily.com/173-small-business-startup-companies-helping-new-job-growth.html. Most government reforms intended to aid small business fail to distinguish between the subset of high potential startups and small businesses generally. Moreover, while startups do generate new jobs, these highly volatile ventures also destroy the most jobs. *Id.* In addition, some experts have suggested that the greatest impediment to startup businesses is the heavy load of college loan debt. *See* Ruth Simon, *Student-Loan Load Kills Startup Dreams*, WALL. ST. J., Aug. 14, 2013, at C1, *available at* http://online.wsj.com/news/articles/SB10001424127887323446404579008930399820764. Many potential entrepreneurs simply cannot invest their time and other resources in hopes of deferred returns but, instead, must seek full time traditional employment in order to earn steady income for student debt repayment. According to Vivek Wadhwa, a Stanford Law School fellow, "[t]he single largest inhibitor to entrepreneurship is the student loans." *Id.* at C2.

8 *See* Tyler Adam, Note, *The JOBS Act: Unintended Consequences of the "Facebook Bill,"* 9 HASTINGS BUS. L.J. 99, 100–01, 113 (2012); *see also* Steven M. Davidoff, *Facebook and the 500-Person Threshold*, N.Y. TIMES (Jan. 3, 2011, 4:03 PM), http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/.

9 *See* JOBS Act §§ 301–305 (2012) (codified in scattered sections of 15 U.S.C.). *See generally* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 87–98; C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 197 (2012); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1754–57 (2012); Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 356–57 (2012); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 937–60 (2011).

10 *See* JOBS Act, Pub. L. No. 112-106, § 601, 126 Stat. 306, 326–27 (2012). *See generally* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339 (2013). For an interesting discussion on pre-enactment pressure for regulatory revisions, see Jean Eaglesham, *U.S. Eyes New Stock Rules: Regulators Move Toward Relaxing Limits on Shareholders in Private Companies*, WALL ST. J., Apr. 8, 2011, at A1, *available at* http://online.wsj.com/news/articles/SB10001424052748704630004576249182275134552.

11 *See* JOBS Act §§ 101–108.

A offerings,[12] and removal of the long standing prohibition on general solicitation in connection with private placements of securities under Rule 506 of Regulation D.[13] The last provision is by far the most radical in its impact on the dual securities regulatory structure in the United States.[14]

Pursuant to the JOBS Act statutory mandate, the Securities and Exchange Commission (SEC) recently amended Rule 506 to eliminate the prohibition on general solicitation in certain private offerings of securities.[15] In one fell swoop, the Commission has authorized issuers to publicly offer unlimited amounts of securities to the whole world through internet websites, print and broadcast media, public presentations and seminars, and even advertisements on buses and billboards, without registration or other presale review by federal or state regulatory authorities. Not only is the issuer free from filing a prolix disclosure document with regulatory agencies, the issuer is not required to prepare and provide any disclosure document for investors. To preserve its exemption from registration, the issuer must only take reasonable steps to "verify" that the actual purchasers are accredited investors,[16] as defined in Regulation D[17] to include, among other categories, individuals that have had annual income of $200,000 (or $300,000 jointly with spouse) for the past two years and expect to have such in the current year,[18] or, alternatively, have a net worth of $1 million, excluding the equity in their primary residence.[19] Although issuers are now permitted to broadcast their marketing campaign to the public (i.e., the nation's population are all offerees), issuers can sell only to accredited investors. At the current thresholds, this group of targeted investors in the United States alone would be roughly 8.5 million households.[20] At Congress's behest in the JOBS Act,

12 *See generally* JOBS Act § 402; Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 79–82 (2006) (discussing the need to revise Regulation A so that it will be a more useable tool for small businesses).

13 *See* JOBS Act § 201. *See generally* Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1, 7, 12–13 (1986); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 68–70 (1989) (arguing for reform to the ban on general solicitations).

14 *See generally* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495 (1984) [hereinafter Warren, *Dual Regulation*].

15 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771, 44,771, 44,774 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242). *See generally Split SEC Clears JOBS Act Advertising Rule, Issues Proposal on Enhanced Requirements*, 45 Sec. Reg. & L. Rep. (BNA) No. 28, at 1285 (Jul. 15, 2013).

16 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. at 44,771.

17 17 C.F.R. § 230.501(a) (2013).

18 *Id.* § 230.501(a)(6).

19 *Id.* § 230.501(a)(5).

20 *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-640, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD

the SEC has recently transformed what originated as a private placement safe harbor under Section 4(a)(2) of the Securities Act of 1933[21] (1933 Act) into a lawful unregistered public offering of securities.[22]

I will not address several issues in this Article that I have addressed elsewhere, including the issue of whether wealth is an appropriate proxy for the intellectual and physical access to material information about issuers and their securities,[23] as required under Section 4(a)(2)[24] according to the Supreme Court in *SEC v. Ralston Purina Co.*[25] While wealth may suggest the ability to fend for one's self, it barely evidences any ability to evaluate the merits and risks of investments in securities. Similarly, I will not address questions associated with the new *verification* requirements that the SEC has imposed with respect to generally solicited Rule 506(c) offerings.[26] Indeed, a rapidly developing cottage industry of independent third party verification services providers has already emerged.[27] Instead, I will address how the elimination of the prohibition on

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BE CONSIDERED 18 (2013) [hereinafter GAO ALTERNATIVE CRITERIA].

21 Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012).

22 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771, 44,804–05 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

23 *See generally* 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, 381–82 (1984) [hereinafter Warren, *Review of Regulation D*].

24 Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2).

25 SEC v. Ralston Purina Co., 346 U.S. 119, 124–27 (1953). *See generally* Manning Gilbert Warren III, *An Essay on Rule 506 of Regulation D: Its Questionable Origins, Regulatory Oblivion and Judicial Revitalization*, 38 SEC. REG. L.J. 4 (2010) [hereinafter Warren, *Essay on Rule 506*].

26 *See* 17 C.F.R. § 230.506(c) (2013). The SEC, in imposing accredited investor verification requirements, provided both a principles-based method of verification and four specific non-exclusive methods of verifying accredited investor status. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. at 44,776, 44,780. The specific methods of verification were adopted by the SEC based on its belief "that the potential for uncertainty and the risk of participation by non-accredited investors is highest in offerings involving natural persons as purchasers." *Id.* at 44,778. Based on my discussions with numerous securities lawyers, the verification methodology most likely to be employed will be self-certification by investors through suitability questionnaires accompanied by representation letters provided by their certified public accountants. Despite its prescribed methodologies, the SEC did express its recognition of "the general concern regarding possible misuse of the new Rule 506(c) exemption to sell securities to those who are not qualified to participate in the offering" and promised to closely monitor the verification practices that evolve. *Id.* at 44,782.

27 *See, e.g.*, ACCREDITED INVESTOR SOLUTIONS, http://www.accreditedinvestorsolutions.com (last visited Mar. 3, 2014); *Accredited Investor Verification*, CROWDBOUNCER, http://www.crowdbouncer.com/accredited-investor-verification (last visited Mar. 21, 2014); *Accreditation Verification on SecondMarket*, SECONDMARKET, http://www.secondmarket.com/education/avp (last visited Mar. 21, 2014); REGISTRY OF ACCREDITED INVESTORS, http://www.registryofaccreditedinvestors.com (last visited Mar. 21, 2014); *The CAI Program*, CROWDENTIALS, http://www.crowdentials.com/cai.php (last visited Mar. 3, 2014). SecondMarket advertises online its "General Solicitation Solution," offering companies and investment funds the opportunity "to offload the entire administrative

general solicitation has affected the states as partners with the SEC in our dual regulatory system.[28]

First, I will describe the regulatory context, briefly detailing the states' already truncated role in the regulation of securities offerings and, more particularly, securities *privately* offered under Rule 506(b) of Regulation D,[29] which might be referred to as the *quiet* Rule 506, as well as the states' equally truncated role in the regulation of *publicly* offered securities under Rule 506(c) of Regulation D,[30] which might be referred to as the *noisy* Rule 506. I will then address the roles the states might assume going forward after this most recent reallocation of regulatory responsibilities. State regulatory authorities have vital responsibilities to their local communities and must devote their resources not only to *late stage*, post–transactional enforcement against abusive issuers and their promoters, but also to *early stage*, presale enforcement in order to protect their targeted populations before they are victimized. I will suggest that state regulators should more intensively scrutinize both types of Rule 506 offerings to ensure that issuers and their promoters are conducting their offerings in satisfaction of the exemption's regulatory conditions, including its new "bad actor" rules.[31] In other words, in a play on the adage, "if you can't beat them, join them," the states should do all that they can to ensure compliance by issuers with the federal Rule 506(b) and 506(c) exemptions. After discussion of the states' regulatory authority to review all Rule 506 offerings of putative covered securities, under what I submit is a complementary state and federal framework, I will recommend uniform Form D review guidelines for further development by state regulators.[32] I will then encourage the North American Securities Administrators Association[33] (NASAA), with the states' full support, to

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burden and heightened regulatory requirements related to generally soliciting [investors]." *See General Solicitation Solution*, SECONDMARKET, http://www.secondmarket.com/education/lending/general-solicitation-solution (last visited Mar. 21, 2014). *See generally* Eric Markowitz, *Here Comes SecondMarket's Second Act*, INC., http://www.inc.com/eric-markowitz/second-market-second-act-sec-ruling.html (last updated July 11, 2013) (explaining the effects of lifting the ban on general solicitation on the third-party investor verification services industry).

28 *See* Warren, *Dual Regulation*, *supra* note 14, at 537.

29 17 C.F.R. § 230.506(b).

30 *Id.* § 230.506(c). Rule 506(c), adopted by the SEC pursuant to the JOBS Act section 201 mandate, finds its statutory authority in section 4(b) of the 1933 Act, providing that the registration provisions of section 5 shall not apply to "[o]ffers and sales exempt under section 230.506 of title 17, Code of Federal Regulations (as revised pursuant to section 201 of the Jumpstart Our Business Startups Act) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." Securities Act of 1933 § 4(b), 15 U.S.C. § 77d(b) (2012); *see also* JOBS ACT, Pub. L. No. 112–106, § 201, 126 Stat. 306, 313 (2012).

31 17 C.F.R. § 230.506(d); *see* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239).

32 *See infra* Part III.A.

33 The North American Securities Administrators Association (NASAA), was formed in 1919 and is the oldest international organization devoted to investor protection. *See* NASAA, http://

promptly implement its long envisioned Electronic Form D depository (EFD) to coordinate the filing and review of Form D notifications required by both Regulation D and the states,[34] as I have previously suggested.[35] Finally, I will strongly recommend that NASAA consider the development of a centralized "bad actor" database (BAD). The database would provide issuers, attorneys, accountants, broker–dealers, and investors access to information about adverse criminal and regulatory histories, which under the SEC's recently adopted Rule 506(d)[36] disqualify issuers from any use of the Rule 506 exemption.[37] A BAD system would not only benefit issuers and their counsel through early stage detection of bad actors in proposed offerings but might also, at least in the absence of actual knowledge, provide a "best practices" method to satisfy the reasonable care exception to disqualification.[38] It would also significantly enhance the far–reaching investor education programs continually developed by the Financial Industry Regulatory Association[39] (FINRA), NASAA, state regulatory authorities, and various nongovernmental organizations (NGOs) to reduce investor susceptibility to fraudulent schemes.[40] Investors, by accessing

www.nasaa.org (last visited Mar. 21, 2014). Its membership includes sixty–seven states, provincial, and territorial administrators in the fifty states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. *Id.*

34 *See infra* Part III.B.

35 *See generally* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U. L.Q. 497 (2000) (extolling the virtues of coordination of state and federal filing requirements in order to promote uniformity) [hereinafter Warren, *Reallocation*].

36 17 C.F.R. § 230.506(d) (2013).

37 *See infra* Part III.C.

38 *See* 17 C.F.R. § 230.506(d)(2)(iv) (2013).

39 The Financial Industry Regulatory Association (FINRA), successor to the National Association of Securities Dealers (NASD), is the self–regulatory organization authorized by Congress to protect investors through the regulation of the securities industry, including more than 4100 securities firms with approximately 635,800 brokers. *About FINRA*, FINRA, http://www.finra.org/AboutFINRA (last visited Mar 21, 2014). The FINRA Foundation has awarded over $83 million in grants for the development of investor protection educational and research programs since 2003. *Id. See generally* FINRA INVESTOR EDUC. FOUND., http://www.finrafoundation.org (last visited Mar. 21, 2014) (highlighting the FINRA Foundation's financial education initiatives through grant funding and programming).

40 NASAA has developed its NASAA Fraud Center to educate investors about investor traps, avoiding scams, and the red flags of fraud. *See Investor Education*, NASAA, http://www.nasaa.org/investor–education (last visited Mar. 21, 2014). Additionally, it has developed a Senior Investor Resource Center and regularly issues investor alerts. *Id.* Its member–state and provincial regulatory agencies have also devoted significant resources to investor education. For example, the Alabama Securities Commission not only provides links to NASAA's investor education programs, but also provides links to Kiplinger's brochures and other investor education materials financed by the Investor Protection Trust. *Investor Education & Fraud Prevention*, ALA. SEC. COMMISSION, http://www.asc.state.al.us/InvestorED.htm (last visited Mar. 21, 2014). The British Columbia Securities Commission has been particularly dedicated to investor protection, developing its InvestRight website to provide investor alerts, information on how to avoid investment scams, and tools for investment decisions. *For Investors*, B.C. SEC. COMMISSION, http://www.bcsc.bc.ca/investors.aspx

a highly publicized BAD system, would be able to identify recidivist bad actors, colloquially referred to as "frequent flyers," before their money is lost in fraudulent schemes. The states, by acting collectively through NASAA to establish a BAD list, would significantly enhance their efforts to protect local investors in their communities. State regulators, not SEC staff in Washington or its eleven regional offices, continue to be the boots on the ground, serving as the only public consumer protection agencies for retail investors.

I. The Regulatory Context of Rule 506 Offerings

A. The Securities Act of 1933

The Securities Act of 1933[41] was adopted "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[42] Section 5 of the 1933 Act,[43] its core provision, makes it unlawful for any person, directly or indirectly, to *offer*[44] any security unless a registration statement containing the prescribed disclosures has been filed with the SEC.[45] Further, Section 5 makes it unlawful for any security to be sold before that registration statement has been declared effective.[46] The statute is highly restrictive on the issuer's communications during the period the issuer is "in registration,"[47] and, generally, with certain key exceptions,[48] prohibits the use

(last visited Mar. 21, 2014). In addition, since 2004 it has successfully incorporated financial literacy materials as a component of Planning 10, a mandatory tenth grade life skills course in British Columbia. *Id.* Its diligence in the field of investor education led Canada's Financial Consumer Agency to license the Planning 10: Finances course and publish it online for free use by teachers throughout Canada. Interview with Ken Gracey, Media Relations, in Vancouver, B.C. Sec. Comm'n (Sept. 27, 2013).

41 Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)).

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

43 Securities Act of 1933 § 5(c), 15 U.S.C. § 77e (2012).

44 The terms "offer to sell," "offer for sale," and "offer" are defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *Id.* § 2(a)(3), 15 U.S.C. § 77b(a)(3).

45 *See id.* § 5(c), 15 U.S.C. § 77e(c).

46 *Id.* § 5(a)(1), 15 U.S.C. § 77e(a)(1).

47 The term "in registration" refers to "the entire process of registration, at least from the time an issuer reaches an understanding with the broker-dealer which is to act as managing underwriter prior to the filing of a registration statement and the period of 40 to 90 days during which dealers must deliver a prospectus." Guidelines for Release of Information by Issuers Whose Securities Are "in Registration," Securities Act Release No. 5180, 36 Fed. Reg. 16,506 n.1 (Aug. 20, 1971).

48 *See generally* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,725 (Aug. 3, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249 & 274). In Securities Offering Reform, the SEC adopted exceptions to the "quiet period" prohibition on pre-filing communications. *Id.* The most noteworthy of these exceptions was for "well-known seasoned issuers," which are permitted to engage in unrestricted oral and written selling activities

of any written communications unless they satisfy the statute's prospectus requirements.[49] Issuers are generally prohibited from any efforts to condition the market for their securities in advance of providing the required disclosures, an unlawful course of action referred to as "gun jumping."[50] Thus, even in connection with full-blown registered public offerings involving intensive due diligence by counsel for the issuer and its underwriters and formal review by the SEC's staff, the issuer is not permitted to engage freely in general solicitation and advertising of its securities to investors. Thus, in a broad sense, the securities laws have not generally permitted issuers in even registered public offerings to engage in unrestricted marketing to the population at large. Reversing this long standing paradigm, the JOBS Act and the SEC's new Rule 506(c) exemption oddly authorize issuers, including non-reporting startup companies, to undertake with impunity unregistered public offerings of securities without any formal disclosure requirements.

At the time the 1933 Act was passed, state regulation of securities, popularly known as "blue sky laws," was well established, with virtually all the states having already passed securities legislation.[51] Indeed, a majority of state administrators advised Congress that because many fraudulent interstate schemes were beyond their reach, "a supplemental federal law [was] needed to stop this gap."[52] Congress, in passing the 1933 Act, as well as the other federal securities statutes, was careful to preserve, and not to preempt, these state regulatory schemes. It specifically enacted a savings clause in the 1933 Act

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before filing a registration statement. *See* 17 C.F.R. § 230.163(a) (2013); Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 573–74 (2007). More recently, Congress provided in section 105(c) of the JOBS Act another exception for "emerging growth companies," which are permitted to communicate with "qualified institutional buyers" and institutional accredited investors to "test the waters" to determine if such investors would be interested in the contemplated securities offering. Securities Act of 1933 § 5(d), 15 U.S.C. § 77e(d) (2012), *amended by* JOBS Act, Pub. L. No. 112–106 § 105(c) 126 Stat. 306, 310 (2012).

49 *Id.* § 5(b), 15 U.S.C. § 77e(b).

50 The prohibition against gun jumping was designed to prevent an issuer from "conditioning the public mind or arousing public interest in the issuer" before the dissemination of accurate and current information through a registration statement filed with the SEC. *See* Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 3844, 22 Fed. Reg. 8359, 8359 (Oct. 24, 1957). *See generally* Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989); Morton A. Pierce, *Current and Recurrent Section 5 Gun Jumping Problems*, 26 CASE W. RES. L. REV. 370 (1976); Comment, *Preregistration Publicity in an Exchange Offer*, 119 U. PA. L. REV. 174, 174–75 (1970); Note, *Prereorganization Negotiations and Securities Act Section 5(c): A Proposed Solution to the Gunjumping Problem*, 24 CASE W. RES. L. REV. 731 (1973).

51 *See* S. REP. No. 73–47, at 2 (1933).

52 *Federal Securities Act: Hearings on H.R. 4314 Before the H. Comm. on Interstate & Foreign Commerce*, 73d Cong., 1st Sess. 93, 101 (1933) (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

preserving the power of the states to regulate securities.[53] In doing so, Congress established a dual regulatory system that has largely flourished ever since.[54]

B. National Securities Market Improvement Act of 1996

Congress dealt a major blow to our dual regulatory system when it passed the euphemistically entitled National Securities Market Improvement Act of 1996[55] (NSMIA). With deregulatory fervor approaching the level of religious zealotry, Congress preempted state registration authority over a broad swath of securities offerings. As I have previously written, Congress, among other things, gutted the states' registration authority over a number of securities and securities transactions that were already exempt from federal registration.[56] Most significantly for this discussion, it preempted state registration for all securities transactions exempt by SEC rule under the private offering exemption set forth in Section 4(a)(2) of the 1933 Act,[57] the only such rule being Rule 506 of the SEC's Regulation D.[58]

Rule 506 had been adopted by the SEC some fourteen years earlier in order to provide a safe harbor under Section 4(a)(2) for "transactions by an issuer not involving any public offering."[59] Although I have seriously questioned the SEC's authority under Section 4(a)(2) to even promulgate Rule 506,[60] after the anointment of securities offered under the rule as "covered securities," it rapidly became the exemption of choice for virtually all issuers intent on sidestepping both the intensive disclosure regime imposed by Section 5 of the 1933 Act and the disclosure regimes of the states. In brief, the rule permits issuers to offer securities in an unlimited aggregate offering amount to an unlimited number of offerees and to an unlimited number of accredited investors without any formal disclosure requirements.[61] Moreover, until recently, it could even be used by so-called "bad actors," a term including convicted felons and others previously found to have violated state and federal securities laws.[62] Under the rule as

53 *See* Securities Act of 1933 § 16, 15 U.S.C. § 77p.

54 Warren, *Dual Regulation*, *supra* note 14, at 497.

55 National Securities Market Improvement (NSMIA) Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

56 *See* Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169 (1997).

57 *See* Securities Act of 1933 § 18(a), (b)(4)(E), 15 U.S.C. § 77r(a), (b)(4)(E).

58 *See* 17 C.F.R. § 230.506 (2013).

59 Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2) .

60 *See* Warren, *Essay on Rule 506*, *supra* note 25.

61 Rule 502(b) of Regulation D specifies comprehensive disclosure requirements for issuers that rely on the Rule 506 exemption from registration, but specifically exempts from these requirements sales of securities to "any accredited investor." 17 C.F.R. § 230.502(b) (2013).

62 The SEC, in its promulgation of Regulation D, disqualified issuers from using the Rule 505 exemption for securities offerings of $5,000,000 or less if the issuer, its affiliates, or securities

originally adopted, the only major constraint imposed on issuers was the rule's prohibition on general solicitation and advertising,[63] and its use was further subject to a condition, later eliminated by amendment,[64] requiring issuers to file a Form D notification with the SEC.[65] While NSMIA granted the states the right to require that those Form Ds also be filed with them, together with filing fees,[66] the statute precluded the states from imposing their own additional disclosure requirements on these unregistered offerings and from conducting any presale review of the disclosures, if any, that the issuer determined to provide offerees and actual purchasers of the offered securities.[67] Although NSMIA radically revised the 1933 Act's savings clause that originally preserved state authority, it did leave the states with the residual authority to investigate and bring enforcement actions for securities fraud,[68] to suspend offerings as a result of the failure to submit required filings and fees,[69] and, presumably, left intact the states' authority to determine the registration and disclosure requirements applicable to issuers of securities that were not deemed "covered securities" and thus free from NSMIA's preemptive effect. However, as historical experience has repeatedly demonstrated, it is exceedingly difficult, if not impossible, for

intermediaries had previously engaged in certain specified conduct that violated the federal securities law. 17 C.F.R. § 230.505(b)(2)(iii) (2013). These "bad boy" disqualifiers were derived from Rule 262 of Regulation A, 17 C.F.R. § 230.262, another regulatory exemption adopted under the authority of section 3(b) of the 1933 Act. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b). However, the SEC did not apply these disqualifiers to issuers using the Rule 506 exemption for securities offerings of unlimited amounts under Rule 506. *See* Warren, *Review of Regulation D*, *supra* note 23, at 380 n.188.

63 *See* 17 C.F.R. § 230.502(c). Rule 502(c), as applied to Rule 506 offerings, prohibited the issuer and any persons acting on its behalf from offering or selling securities "by any form of general solicitation or general advertising, including, but not limited to . . . [a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and . . . [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising." *Id.*

64 Regulation D; Accredited Investor and Filing Requirements, Securities Act Release No. 6825, 54 Fed. Reg. 11,369, 11,370 (Mar. 20, 1989) (to be codified at 17 C.F.R. pts. 200, 230 & 239). In eliminating the filing of Form D as a condition to the availability of the Regulation D exemptions, the SEC added Rule 507, 17 C.F.R. § 230.507, to provide an incentive for issuers to file the Form Ds. *See id.* For a general discussion of this regulatory evolution, see Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. 10,592 (Feb. 27, 2008) (to be codified at 17 C.F.R. pts. 230, 232 & 239).

65 17 C.F.R. § 230.503(a) (2013).

66 *See* NSMIA § 102(a) (1996), 15 U.S.C. § 77r(c)(2)(A) (2012).

67 *See* § 102(a), 15 U.S.C. § 77r(a)(1)–(3).

68 § 102(a), 15 U.S.C. § 77r(c)(1).

69 § 102(a), 15 U.S.C. § 77r(c)(3).

investors to recover their investment losses after the fact from dishonest issuers and promoters.[70] One prominent state regulator has portrayed this dilemma as follows:

> I know a guy who has a match and intends to burn down the forest, but I cannot walk over and blow out that match. Instead, I have to wait until the forest has been set on fire before I'm allowed to call in the fire department. Even if I catch the arsonist, the trees are gone.[71]

NSMIA's preemption of the states' authority to monitor their own registration and exemptive schemes through presale review has severely diminished their roles as gatekeepers for the protection of investors in their respective communities.

By preempting state registration authority over securities issued pursuant to Rule 506, Congress channeled offerings away from other federal exemptive schemes in to Rule 506. Once NSMIA's preemptive effect was in place, issuers and their counsel, by resort to Rule 506, could lawfully avoid disclosure requirements applicable under the registration and exemptive schemes of the states, as well as related compliance costs and potential liabilities. Offerings under any other federal exemption from registration, including, among others, the statutory intrastate exemption at Section 3(a)(11) of the 1933 Act,[72] the private placement exemption at Section 4(a)(2),[73] and the small offering exemptions promulgated under Section 3(b),[74] remained subject to pre–offer or presale scrutiny at the state level, either under state registration requirements or state exemptions from registration that provide additional investor protection.[75] Congressional engineering through NSMIA ensured the issuer's default resort to the federally exempted and state preempted Rule 506.[76]

Moreover, Congress deprived investors of the presale protection that had been previously provided by state regulatory schemes and state regulatory authorities.

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70 *See, e.g.*, Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks on Increasing the Vulnerability of Investors (Aug. 29, 2012), *available at* http://sec.gov/news/speech/2012/spch082912laa.htm ("In most cases, much of investors' monies are long gone by the time a fraud is identified and an action can be brought.").

71 Interview with Joseph P. Borg, Director, Alabama Securities Commission (Sept. 18, 2013).

72 Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012).

73 *See id.* § 4(a)(2), 15 U.S.C. § 77d(a)(2).

74 *Id.* § 3(b), 15 U.S.C. § 77c(b). Under its section 3(b) authority, the SEC has promulgated exemptions from registration in Rules 504 and 505 of Regulation D, 17 C.F.R. §§ 230.504–.505 (2013), and Regulation A, 17 C.F.R. §§ 230.251–.263 (2013).

75 See Rutheford B Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcome for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 922 (2011). Congress inexplicably preempted state regulatory authority over securities offerings compliant with an SEC administrative rule, subject to administrative repeal or amendment by the SEC at any time. *Id.* At the same time, this largely left the 1933 Act's *statutory* exemptive scheme in place, with complementary state regulation, in the dual regulatory system. *Id.* I agree, at least in part, with my colleague Professor Campbell, that in its enactment of NSMIA, Congress "wrecked" the statutory exemptive regime for securities offerings.

76 *Id.*

Since NSMIA's enactment, state regulatory authorities have experienced a surge in investor complaints against dishonest issuers and their promoters who were enabled to launch their offerings without any federal or state presale review and, thereafter, abscond with the savings of investors.[77] Moreover, state registrations of local offerings exempt under the federal intrastate exemption have virtually disappeared. Congress, as I have stated previously,[78] apparently forgot that it enacted many of the federal exemptions, including the private placement exemption under which Rule 506 was promulgated, based on its own recognition that the states already provided sufficient presale protection for investors.[79] It has long been recognized that investors in unregistered private offerings, particularly those in which no reputable financial intermediaries are involved, need more protection than in any other type of securities offering.[80] Yet Congress not only chose to exempt these offerings from its federal regime, but it also chose to preempt the states from implementing their own regulatory regimes regarding these private offerings of securities.[81] In doing so, it created a huge *regulatory gap* for the very offerings in which investors need the most protection.

Following passage of NSMIA, issuers, with understandable expedience, made Rule 506 their federal exemption of choice under Regulation D. According to a recent report prepared by the SEC's Division of Economic and Risk Analysis (DERA) analyzing Form Ds electronically filed with the SEC, as required by Regulation D, some 99% of the amounts of securities sold, approaching $1 trillion annually, were offered in reliance on Rule 506.[82] Almost

77 *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 29, app. at 1–12 (2011) [hereinafter *Abshure Testimony*] (statement of Heath Abshure, Arkansas Securities Comm'r, on behalf of North American Securities Administrators Association, Inc. (NASAA)), *available at* http://www.gpo.gov/fdsys/pkg/CHRG–112hhrg72604/pdf/CHRG–112hhrg72604.pdf. According to former NASAA President Jack Herstein, NSMIA's preemption of state authority to review Rule 506 offerings prior to sales made the Rule 506 exemption "a haven for investment fraud," and "the most frequent source of enforcement cases handled by state securities regulators." Jack E. Herstein, *Election–Year Politics Trump Investor Protection*, HILL (Mar. 15, 2012, 8:52 PM), https://www.thehill.com/blogs/congress–blog/politics/216339–election–year–politics–trump–investor–protection.

78 *See* Warren, *Dual Regulation*, *supra* note 14, at 515.

79 *Id.*; *see also* Warren, *Reallocation*, *supra* note 35, at 504.

80 *See* Edward M. Cowett, *Federal–State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 293 n.36 (1959) ("[T]he greatest measure of protection [for the residents of the respective states] is warranted in the case of such securities or transactions."); Thomas Z. Wright, *Correlation of State Blue–Sky Laws and the Federal Securities Acts*, 26 CORNELL L.Q. 258, 271 (1941) ("[T]here arises here a group of securities in the regulation of which the [states] must continue to be vigilant if adequate investor protection is to be rendered . . . ."). *See also* Warren, *Dual Regulation*, *supra* note 14, at 519.

81 *See* Warren, *Reallocation*, *supra* note 35, at 498–99.

82 VLADIMIR IVANOV & SCOTT BAUGUESS, U.S. SEC. & EXCH. COMM'N, DIV. OF ECON. & RISK ANALYSIS, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012, at 11 (2013) [hereinafter DERA 2013 STUDY],

90% of these issuers reported that they did not use financial intermediaries, namely broker-dealers, in conducting their private offerings.[83] During a period commencing in 2009, when the SEC first mandated the electronic filing of Form D,[84] and ending in 2012, nonfinancial issuers engaged in over 40,000 private offerings with a median offer size of under $2 million,[85] and those issuers that were "not pooled investment funds" generally conducted offerings for $1 million or less.[86] In addition, two-thirds of all Regulation D offerings represented new equity capital and not debt securities.[87] Moreover, the study reported that 90% of these offerings were purportedly made solely to accredited investors.[88] Most significantly, the study concluded that the evidence reviewed suggested "an active and vibrant market for private offerings compared to registered offerings, and [that this] is inconsistent with the view that there are significant frictions in the capital raising process that prevent issuers from funding investment through private offering channels."[89] It surmised, in effect, that the evidence did not support frequently heard claims that the SEC's rules somehow stifled private investment in the nation's small businesses.[90]

C. The JOBS Act

Despite this lack of evidence and, indeed, with an excessively deregulated securities marketplace for unregistered offerings of securities in which neither the SEC nor the states engaged in presale review of those offerings, Congress enacted the JOBS Act in 2012 to further deregulate our securities markets. In an election year, with enormous political pressure on both parties to do something about the high unemployment rate lingering from the Great Recession of 2008, Congress, with its public approval rating at 9%,[91] could hardly vote against a statute superficially hailed as a historically significant job creation measure.[92] The JOBS Act was a package of bills designed to eliminate

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available at http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

83 *See id.* at 16.

84 Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. 10,592, 10,592 (Feb. 27, 2008) (to be codified at 17 C.F.R. pts. 230, 232 & 239).

85 DERA 2013 STUDY, *supra* note 82, at 12 fig.6b & tbl.3.

86 *Id.* at 12.

87 *See id.* at 9, 10 fig.5.

88 *See id.* at 3.

89 *Id.* at 10.

90 *Id.* at 5.

91 *See* 158 CONG. REC. S1687 (daily ed. Mar. 15, 2012) (statement of Sen. McConnell).

92 Indeed, the JOBS Act, originated by President Barack Obama's Council on Jobs and Competitiveness—two-thirds of which were corporate chairmen and CEOs—was a "boon for venture capitalists, large tech companies and Wall Street banks." Zach Carter & Ryan Grim, *Obama JOBS Act Leaves Labor Fuming in Democratic Feud*, HUFFINGTON POST (Apr. 5, 2012, 11:39AM),

or weaken federal and state securities laws as they applied to small businesses on the grounds that these laws, as opposed to rational market restraints, were the principal barriers to capital formation. The crowdfunding bill, first introduced as the Entrepreneur Access to Capital Act and endorsed by the Obama Administration, provides a new registration exemption for crowdfunded securities offerings to retail investors.[93] Although not yet implemented by SEC rules that Congress mandated in the statute, the JOBS Act authorizes issuers to engage in unregistered, generally solicited offerings of securities to the general public, with no requirement that investors be accredited.[94] It further

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http://www.huffingtonpost.com/2012/04/05/obama-jobs-act-labor_n_1404401.html. With broad bipartisan support, the measure was adopted "despite vocal opposition from consumer advocates, federal regulators and the largest U.S. coalition of labor unions, who warned of increased risk of financial fraud." *Id.* Both President Obama and House Majority Leader Eric Cantor were said to be "eager for a bipartisan photo-op." *Id.*

93 Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011), 157 CONG. REC. H6181 (daily ed. Sept. 14, 2011) (statement of Rep. McHenry); *see* Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(4)(a)(6) (2012). The statutory exemption states that the registration provisions of the 1933 Act shall not apply to transactions

> involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—(A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than $1,000,000; (B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—(i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000; (C) the transaction is conducted through a broker or funding portal that complies with the requirements of section 4A(a); and (D) the issuer complies with the requirements of section 4A(b).

Id.

94 The SEC recently proposed, but has not yet adopted, crowdfunding rules that essentially follow the statutory structure established by Title III of the JOBS Act and codified at section 4(a)(6) of the 1933 Act. *See* Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70,741, 78 Fed. Reg. 66,429 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240 & 249). In the SEC's view, Congress enacted the crowdfunding exemption "to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts." *See id.* at 66,430. The proposed rules have been designed to present the general public, accredited and non-accredited investors alike, with "an opportunity to invest in an idea or business and individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd." *See id.* After the SEC proposed its crowdfunding rules, one reporter questioned whether crowdfunding "will thrive or become largely a vehicle for fraud." *See* Steven M. Davidoff, *Trepidation and Restrictions Leave Crowdfunding Rules Weak*, N.Y. TIMES, Oct. 30, 2013, at B5, *available at* http://dealbook.nytimes.com/2013/10/29/trepidation-and-restrictions-leave-crowdfunding-rules-weak/. Observing that even the experts in startup investments, the venture capitalists, have only a 20% success rate, he concluded that "you will have better odds at the casino than investing in crowdfunded companies." *Id.* Indeed, state securities regulators have predicted that "a combination of fraud, high failure rates for startups and an 'inevitable advertising onslaught of pie-in-the-sky offers' will kill investor confidence in buying shares online." *See* Jean Eaglesham,

designates these securities "covered securities," thus preempting registration or any other form of presale review by the states.[95] Professor John Coffee, in testimony before the Senate Banking Committee, stated that the bill, which he characterized as the "The Boiler Room Legalization Act of 2011," would likely create "few jobs . . . and much fraud."[96] Other measures enacted in the JOBS Act include the creation of an on-ramp for a new category of issuers designated as emerging growth companies (EGCs) with relaxed disclosure requirements,[97] an increase in the number of shareholders a company must have before triggering registration and periodic reporting requirements under the Securities Exchange Act of 1934 (1934 Act)—from 500 shareholders to 2000 shareholders (subject to a maximum of 500 non-accredited investors),[98] an increase in the amount that can be raised in a Regulation A offering from $5 million to $50 million,[99] and, incredibly, the elimination of the long standing ban on general solicitation in Rule 506 offerings.[100] Professor John Coates, a Harvard economist, agreed with similar testimony from Professor Coffee that the deregulation achieved by the JOBS Act would not create jobs.[101] In fact, Professor Coates testified that investors generally respond to weakened investor protection by demanding an increased risk premium.[102] According to his testimony, the JOBS Act would actually ratchet up the cost of capital, negating and possibly exceeding any savings in compliance costs the legislation might produce.[103]

Crowdfunding Efforts Draw Suspicion, WALL ST. J., Jan. 18, 2013, at C1, *available at* http://online.wsj.com/news/articles/SB10001424127887323783704578247380848394600. For a compendium of recent scholarship on the crowdfunding exemption, see articles cited *supra* note 9.

95 Securities Act of 1933 § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C).

96 *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 13, 61, 64 (2011) (prepared statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d580503c-a7f3-4db5-b9f5-968d03af374f.

97 *See* JOBS Act, Pub. L. No. 112-106, §§ 101-108, 126 Stat. 306, 307-313 (2012) (codified in scattered sections of 15 U.S.C.).

98 *See id.* §§ 303(a), 501 (codified at 15 U.S.C. § 78*l*(g) (2012)); *see also* Div. of Corp. Fin., *Jumpstart Our Business Startups Act, Frequently Asked Questions on Changes to the Requirements for Exchange Act Registration and Deregistration*, U.S. SEC. & EXCHANGE COMMISSION (Apr. 11, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjobsactfaq-12g.htm.

99 *See* JOBS Act § 401(b)(2) (codified at 15 U.S.C. § 77r(b)(4)(D) (2012)); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS 2 (2012).

100 *See* JOBS Act § 201 (codified at 15 U.S.C. § 77d(b)(2)).

101 *See Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 4-5, 27-28 (2011) (statement of John C. Coates IV, John F. Cogan Jr. Professor of Law and Economics, Harvard Law School), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=1d24b42e-3ef8-4653-bfe8-9c476740fafa.

102 *See id.* at 30-31.

103 *See id.* at 28, 30-37.

Before its enactment as Title II of the JOBS Act, the bill directing the SEC to eliminate the ban on general solicitation under Rule 506 originally provided for an amendment of Section 4(a)(2) of the 1933 Act.[104] This amendment would add to Section 4(a)(2)'s statutory exemption for "transactions by an issuer not involving any public offering" the proviso: "whether or not such transactions involve general solicitation or general advertising."[105] If this language had been enacted, it would have rendered unintelligible the entire regulatory scheme of the 1933 Act. Section 5's required *registration* of public offerings would be juxtaposed against a revised Section 4(a)(2) providing an *exemption* of public offerings from registration. The Supreme Court's decision functionally interpreting the term "public offering"[106] and the historically recognized parameters of the Section 4(a)(2) exemption would have been eviscerated. Fortunately, the proposed Section 4(a)(2) amendment was stricken from the bill because of the *fear of unintended consequences.*[107] The JOBS Act, as revised, added a new Section 4(b) to the 1933 Act providing that offers and sales exempt under the SEC's Rule 506 "shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation."[108] It directed the SEC to revise Rule 506 to ensure that

104 Access to Capital for Job Creators Act, H.R. 2940, 112th Cong. (2011) (as passed by House), 157 CONG. REC. H6230–31 (daily ed. Sept. 15, 2011) (statement of Rep. McCarthy).

105 H.R. 2940 § 2(a) (proposing amendment to section 4(a)(2) of Securities Act of 1933); *see also* 158 CONG. REC. H1260–61 (daily ed. Mar. 7, 2012) (statement of Rep. McCarthy). After its introduction by Rep. Kevin McCarthy (R–CA) on September 15, House Bill 2940 was passed in the House by a 413–11 vote on November 3, 2011. *Legislative Digest, H.R. 2940*, GOP.Gov (Nov. 3, 2011), http://www.gop.gov/bill/112/1/hr2940. Senator John Thune (R–SD) introduced the bill in the Senate as Senate Bill 1831 on November 9, 2011. Access to Capital for Job Creators Act, S. 1831, 112th Cong. (2011). Instead of the Senate voting on Senate Bill 1831, it was re–incorporated into a larger legislative package introduced by Rep. Stephen Fincher on Dec. 8, 2011 as House Bill 3606, which would eventually become the JOBS Act. Reopening American Capital Markets to Emerging Growth Companies Act, H.R. 3606, 112th Cong. (2011). Title II of the JOBS Act replaced its predecessor bill, House Bill 2940. *Compare* H.R. 3606, *with* JOBS Act, Pub. L. No. 112–106, § 201, 126 Stat. 306, 313–315 (2012). Subsequently, Rep. McCarthy offered Amendment 10, which would narrow the legislative course the bill would take to allow general solicitation in Rule 506 offerings sold only to accredited investors (i.e., the amendment struck the additional proviso to section 4(a)(2) of the Securities Act of 1933 and simply directed the SEC to eliminate the ban on general solicitation under Rule 506). 158 CONG. REC. H1260–61 (daily ed. Mar. 7, 2012) (statement of Rep. McCarthy); *see also* JOBS Act § 201(a).

106 *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953).

107 Rep. Kevin McCarthy, after his bill's passage by the House of Representatives and its reincorporation in House Bill 3606 as Title II of the JOBS Act, proposed Amendment 10 to strike the section 4(a)(2) amendment and to add a new section 4(b) to the 1933 Act directing the SEC to eliminate the ban on general solicitation in offerings exempt under Rule 506 and sold only to accredited investors. *See* 158 CONG. REC. H1260–61 (daily ed. Mar. 7, 2012) (statement of Rep. McCarthy). In support of his amendment, Rep. McCarthy explained that his amendment resulted from consultation with the SEC that led him to realize that "the language in the bill could have had some unintended consequences that may have limited the effectiveness of the provision or expanded its reach beyond what we originally intended." *Id.* at H1260.

108 JOBS Act § 201(b)(2) (codified at 15 U.S.C. § 77d(b) (2012)).

the prohibition on general solicitation and general advertising in Rule 502(c) of Regulation D shall not apply to offers and sales made pursuant to Rule 506(c), "provided that all purchasers of the securities are accredited investors."[109] The revised bill stated further that issuers be required "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."[110] Congress's efforts to avoid "unintended consequences" demonstrated a startling failure to comprehend its own regulatory scheme under the 1933 Act. To legislate a generally solicited private offering exemption under an SEC rule promulgated under the authority of a statutory Section 4(a)(2) exemption that does not permit general solicitation is patently absurd.

NASAA, state securities regulatory agencies, the Consumer Federation of America (CFA), the American Association of Retired Persons (AARP), numerous other organizations, and individuals testified against the JOBS Act, with particular intensity against Title II lifting the ban on general solicitation in Rule 506 offerings.[111] Heath Abshure, the Arkansas Securities Commissioner and former NASAA president, in his testimony against the legislation, emphasized the pernicious impact NSMIA's preemption of state regulatory authority over Rule 506 offerings had already had on investors throughout the country.[112] Because private offerings, as a result of NSMIA, "receive virtually no regulatory scrutiny," he explained, "the exemption is being misused to steal millions of dollars from investors through false and misleading representations in offerings that provide the appearance of legitimacy without any meaningful scrutiny of regulators."[113] Providing specific examples of securities fraud suffered by retirees, the disabled, and other investors in Rule 506 offerings, he advised that NASAA had identified private offerings as one of "the top trap[s] facing investors."[114] His words fell on deaf ears. Instead of heeding the serious concerns of state regulators and other investor advocates, Congress decided to exacerbate investor risks by extending Rule 506's preemptive effect from privately offered Rule 506 securities to publicly offered Rule 506 securities.[115] While the states had previously been able to enjoin issuers who violated the general solicitation restraint on Rule 506 offerings, they would no longer be able to do so. Congress, in Title II of the JOBS Act, ordered the SEC to amend Rule 506 to allow

109 JOBS Act § 201(a)(1).

110 *Id.*

111 During the JOBS Act debate, Senator Mary Landrieu (D–LA) submitted for inclusion in the Congressional Record numerous letters in opposition, including letters submitted by the AARP, NASAA, the Council of Institutional Investors, and the AFL–CIO. 158 CONG. REC. S1716–26 (daily ed. Mar. 15, 2012) (statement of Sen. Landrieu).

112 *See Abshure Testimony*, *supra* note 77, at 29 app. at 57–59.

113 *Id.* at 58.

114 *Id.*

115 *See* JOBS Act § 201 (extending Rule 506's preemptive effect to publicly offered Rule 506 securities).

issuers to publicly offer Rule 506 securities, working a monumental expansion of NSMIA's preemptive effect.[116]

D. The Dual Rule 506 Exemptions

The SEC, as the federal government's only investor protection agency, was understandably unenthusiastic about implementing the JOBS Act mandate to amend Rule 506 to allow generally solicited private offerings.[117] During a protracted period following enactment of the JOBS Act, the SEC reviewed public comments on how it should implement Congress's mandate.[118] Subject to relentless pressure to act within the JOBS Act's ninety-day deadline, the SEC even considered whether to issue an interim final rule.[119] The SEC pushed back and ultimately decided not to issue an interim rule but to propose Rule 506(c) and related measures for public comments.[120] Almost a full year later, the SEC adopted final rules lifting the ban on general solicitation in Rule 506 offerings

116 *Id.*

117 *See The JOBS Act in Action Part II: Overseeing Effective Implementation that Can Grow American Jobs: Hearing Before the Subcomm. on TARP, Fin. Servs. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 5(2012) (statement of Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg75590/pdf/CHRG-112hhrg75590.pdf (testifying that the 90-day deadline imposed by the Act "simply does not provide time for drafting a new rule . . . .").

118 Soon after the JOBS Act became law, the SEC invited comments on the JOBS Act initiatives to assess views of the general public before proposing rules as mandated by the statute. *See Public Comments on SEC Regulatory Initiatives Under the JOBS Act*, U.S. SEC. & EXCHANGE COMMISSION (June 25, 2012), http://www.sec.gov/spotlight/jobsactcomments.shtml. For comments related to Title II's elimination of the prohibition of general solicitation in Rule 506 offerings, see *Comments on SEC Regulatory Initiatives Under the JOBS Act: Title II - Access to Capital for Job Creators*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml (last modified Jan. 27, 2014).

119 *See* Joe Mont, *SEC Won't Issue Interim Rule for Private Placement Pitches, Delays Meeting*, COMPLIANCE WEEK (Aug. 20, 2012), http://www.complianceweek.com/sec-wont-issue-interim-rule-for-private-placement-pitches-delays-meeting/article/255245. The SEC originally planned to fast-track regulatory implementation of the statutory abolition of the ban on general solicitation under the Rule 506 exemption. *See* Jean Eaglesham & Telis Demos, *SEC Chief Shapiro Delayed Rule Over Legacy Concerns*, WALL ST. J. (Dec. 2, 2012 7:44 PM), http://online.wsj.com/news/articles/SB10001424127887324205404578153693968634504. In May 2012, the SEC staff recommend the commissioners issue an "interim final rule" in August immediately ending the ban. *Id.* After strong opposition was expressed by the Consumer Federation of America, SEC Chairman Mary Schapiro, fearing she would be "tagged with an Anti-Investor legacy," decided to follow the customary rulemaking process requiring public notice and comments on rule proposals. *Id.* Adoption of an interim rule was strongly opposed by numerous consumer and investor protection advocates. *See e.g.*, Letter from Fund Democracy, Inc., et al. to Mary Shapiro, Chairman, Sec. Exch. Comm'n (Aug. 15, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-59.pdf.

120 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9354, 77 Fed. Reg. 54,464 (proposed Sept. 5, 2012) (to be codified at 17 C.F.R. pts. 230 & 239).

to *verified* accredited investors.[121] The final rule, in effect, bifurcates Rule 506 into two distinct exemptions: The first retains the traditional Rule 506 exemption, as Rule 506(b),[122] for offerings made to accredited investors, non–accredited investors, or both, in which general solicitation is prohibited. The second establishes a new Rule 506(c)[123] exemption for generally solicited offerings sold solely to *verified* accredited investors.[124] It is important to note that issuers relying on the Rule 506(c) exemption will not be able to also rely on the statutory private placement exemption (or the Rule 506(b) exemption) since any use of general solicitation in a Rule 506(c) offering would preclude that reliance.[125] As stated by the SEC in its release, "[A]n issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)."[126] The JOBS Act mandate, according to the SEC, was intended to affect only the Rule 506 safe harbor and not Section 4(a)(2) offerings in general.[127] It is hard to imagine the drafters at the SEC wrote these new rules with straight faces. If Section 4(a)(2) of the 1933 Act does not permit public advertising, then how could Rule 506(c), a rule issued under the authority of Section 4(a)(2), be compatible with that prohibition? The answer, I suppose, is that Congress simply legislated this absurd result, that is, "reality is what we say it is." The SEC, in convoluted logic, essentially agrees: "Congress' directive in Section 201(a)(1) of the JOBS Act, and not Section 4(a)(2) of the Securities Act or our interpretation of Section 4(a)(2), is the reason that Rule 506, '. . . shall continue *to be treated as* a regulation issued under

121 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

122 *See* 17 C.F.R. § 230.506(b) (2013).

123 *Id.* § 230.506(c).

124 The SEC was required by section 201(a)(1) of the JOBS Act not only to eliminate the general solicitation prohibition in Rule 506 offerings made solely to accredited investors, but also to require that issuers "'take reasonable steps to verify that purchasers of the securities are accredited investors . . . .'" *See* Securities Act Release No. 9354, 77 Fed. Reg. at 54,465. In its final rule, the SEC declined to specify verification methods, opting for a principles–based approach and providing non–exclusive methods for verifying accredited investor status. *See* Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. at 44,778.

125 *See* Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. at 44,774.

126 *Id.*

127 *Id.* The SEC has recently interpreted Rule 506(c) to preclude "fall back" reliance on Section 4(a)(2) by issuers who have engaged in general solicitation, stating that "[t]he use of general solicitation continues to be incompatible with a claim of exemption under Section 4(a)(2)." *Securities Act Rules: Compliance and Disclosure Interpretations (C&DI's), Question 260.13*, U.S. SEC. & EXCHANGE COMMISSION (Nov. 13, 2013), http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

Section 4[(a)](2) of the Securities Act of 1933.'"[128] Section 4(a)(2) thus has an anomalous statutorily mandated regulatory exception.

E. Rule 506 Disqualification Under Bad Actor Rules

Regulation D has been marred since promulgation with a major and somewhat inexplicable regulatory incongruity. When promulgated, Regulation D prohibited issuers from relying on the Rule 505 exemption if they had certain adverse regulatory histories but allowed issuers relying on the Rule 506 exemption to proceed without regard to those adverse regulatory histories. To rectify this anomaly, Congress, in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010[129] (Dodd–Frank Act), legislated a mandate to the SEC to amend Rule 506 to *disqualify* securities offerings involving certain felons and other bad actors, so–called "bad boys," from reliance on Rule 506.[130] Pursuant to that mandate, the SEC proposed amendments to Rule 506 but delayed adopting final rules for over two years.[131] On the same day it promulgated Rule 506(c), as discussed above, the SEC adopted disqualifying provisions in a new Rule 506(d) under Regulation D.[132] Consequently, an issuer will not be entitled to rely on either the traditional Rule 506(b) exemption or its new Rule 506(c) counterpart if the issuer, its affiliates or predecessor issuers, its executive officers (or other officers participating in the offering), its general partners or managing members, its major shareholders (20% beneficial owners), its promoters and those soliciting purchasers for direct or indirect remuneration, and any director, executive officer, general partner, or managing member of such solicitors have been subject to certain *disqualifying events* within prescribed five and ten year time frames.[133] These disqualifying events include, among others, felony and misdemeanor convictions related to securities transactions, false filings, judicial and administrative orders restraining securities related conduct or practices, certain state securities, banking and insurance authorities' final orders, SEC orders suspending or revoking registration, and other orders delimiting securities related activities.[134] Issuers are now required to *certify* in

128 JOBS Act, Pub. L. 112–106, § 201(a)(1) 126 Stat. 306, 314 (2012) (codified in scattered sections of 15 U.S.C. (2012) (emphasis added).

129 Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 & 15 U.S.C.).

130 *Id.* § 926, 124 Stat. at 1851.

131 *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9211, 76 Fed. Reg. 31,518 (proposed June 1, 2011) (to be codified at 17 C.F.R. pts. 230 & 239).

132 17 C.F.R. § 230.506(d) (2013); *see* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239).

133 17 C.F.R. § 230.506(d).

134 *Id.* The SEC has interpreted Rule 506(d) to exclude disqualifying events that have occurred in foreign jurisdictions, including convictions, court orders, injunctions by foreign courts,

Form D that they are not disqualified from reliance on Rule 506.[135] However, issuers are provided with a *reasonable care* defense if they can demonstrate that they actually made *factual inquiries* into whether disqualifications existed.[136] Moreover, the SEC has provided in Rule 506(d) that the rule will apply only to disqualifying events that occur after its effective date.[137] Most significantly, however, should an issuer conduct an offering while subject to disqualification under Rule 506(d), it not only loses its Rule 506 exemption but may also become subject to applicable state registration requirements.[138] The imposition of "bad

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and regulatory orders issued by foreign regulatory authorities. *Securities Act Rules: Compliance and Disclosure Interpretations (C&DI's), Question 260.20*, U.S. SEC. & EXCHANGE COMMISSION (Dec. 4, 2013), http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

135 *Id.*

136 *Id.* § 230.506(d)(2). While stating that "the concept of reasonable care necessarily includes inquiry by the issuer into the relevant facts," the SEC chose not to prescribe any specific steps issuers should take in order to satisfy the rule's reasonable care standard. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,746. The steps that should be taken, according to the SEC, "will vary according to the particular facts and circumstances." *Id.* The SEC has stated that issuers are likely to have in-depth knowledge of their own officers gained as a result of the hiring process and the employment relationship and, accordingly, further steps may not be required. *Id.* It added that "[f]actual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement." *Id.* at 44,747. Where the issuers do not have in-depth knowledge of their own officers and other "covered persons," they would be required to undertake more extensive factual inquiries. Unfortunately, as the SEC has acknowledged, "there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether covered persons have a disqualifying event in their past." *Id.* at 44,746. Most practitioners recognize that the new bad actor rules impose significant due diligence obligations on issuers and their counsel. For example, two practitioners recently observed that "in order for a lawyer to issue an opinion that the offering complies with the new private offering regime, that lawyer will have to conduct a substantial and costly due diligence." Andrew J. Rosell & Stas Getmanenko, *Reg. D Revamp Could Dampen Growth Capital Market*, LAW360 (Oct. 30, 2013, 6:25 PM), http://www.law360.com/articles/484622/reg-d-revamp-could-dampen-growth-capital-market.

137 17 C.F.R. § 230.506(d)(2)(i). The SEC's bad actor rules require issuers to provide written disclosure of all matters that would have triggered disqualification but for the fact that the disqualifying events occurred before the effective date of the rules. *Id.* § 230.506(e). Moreover, the SEC "expect[s] that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors." Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,749. If an issuer should fail to adequately disclose this information to investors, whether accredited or nonaccredited, it would be precluded from reliance on the Rule 506 exemption from registration. *See id.* According to the SEC, such a disclosure failure would not be considered an "insignificant deviation" from Rule 506 requirements and, consequently, would not be protected by Rule 508 of Regulation D, 17 C.F.R. § 230.508. *See id.* at 44,749–50. The SEC stated that "[d]isclosure of pre-existing triggering events under new Rule 506(e) is intended to benefit all investors by alerting them to any bad actors associated with the issuer or the offering," and, therefore, is a requirement directly intended to protect offerees and purchasers. *See id.*

138 Issuers who are ineligible to rely on Rule 506 will not be able to claim Rule 506's

boy" rules on Rule 506 issuers creates a pathway for state regulatory authorities to monitor Rule 506 issuers and their promoters to ensure that they do not have adverse regulatory histories, providing vital protection to prospective investors. If any of the participants identified under Rule 506(d) are *bad actors*, the issuer may well lose its preemption shield and become fully subject to prosecution for failure to register its securities, in addition to prosecution for misrepresenting or omitting to disclose the involvement of bad actors, for misrepresenting the offering as exempt from registration and for making a false or misleading filing with the state regulators.[139] Certainly, Rule 506(d) has been the only "good news" for state regulators in the wake of the SEC's promulgation of Rule 506(c).

F. The Proposed Amendments to Rule 506

The SEC, in the interim between proposing and promulgating Rule 506(c), received numerous comment letters from NASAA and other investor advocates strongly urging it to complement the new rule with protective safeguards intended to ameliorate potential harms to investors that would likely result from the JOBS Act mandate. These commentators recommended that the SEC revise the individual accredited investor wealth based criteria and, at the very least, factor in inflation over the thirty-year period since those criteria were set.[140] They also asked the Commission to make an issuer's filing of the Form

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preemption benefit and will be subject to the requirements of state securities laws in those states where they have engaged in the offer or sale of securities. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,731.

139 Issuers who falsely certify that no bad actors are involved in their offerings, a new requirement set forth in Form D, have likely made a misrepresentation of a *material* fact actionable under both federal and state antifraud provisions. *See, e.g.*, DEL. CODE ANN. tit. 6, § 73-201 (Supp. 2012); 17 C.F.R. § 240.10b-5 (2013). Similarly, issuers who falsely represent their offerings to be exempt from state and federal registration requirements have likely made a misrepresentation of a *material* fact, arguably providing the basis for both state and federal enforcement of respective antifraud regimes and private causes of action for securities fraud. *Id.*

140 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9354, 77 Fed. Reg. 54,464, 54,466 (proposed Sept. 5, 2012) (to be codified at 17 C.F.R. pts. 230 & 239); Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 2, 7 (May 21, 2012), *available at* http://www.ici.org/pdf/26174.pdf (recommending an updated accredited investor definition with higher income and net worth thresholds and the inclusion of a new category of "accredited natural persons"). The individual accredited investor thresholds promulgated in 1982, $200,000 annual income and $1,000,000 net worth, had the same buying power when adopted as $482,812 and $2,414,062, respectively, had in 2013. *See CPI Inflation Calculator*, BUREAU LAB. STAT., U.S. DEP'T LABOR, http://www.bls.gov/data/inflation_calculator.htm (last visited Mar. 22, 2014). Conversely, in 2013 dollars, the income criterion in 1982 was $82,848 per year and the net worth criterion was $414,240. *See id.* Indeed, one commentator specifically recommended that the accredited investor income and net worth criteria be increased, respectively, from $200,000 to $400,000, and from $1 million to $2.5 million. Letter from Mercer Bullard, President, Fund Democracy, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n, 6 (May 24, 20012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf.

D a *condition* to use of the Rule 506 exemption,[141] to require that the Form D be filed in advance of the commencement of any Rule 506 offering involving general solicitation,[142] and to improve the content requirements of the Form D itself.[143] The SEC rejected calls for redefinition of individual accredited investors based on Dodd–Frank Act restrictions,[144] but it did incorporate aspects of the

141 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9354, 77 Fed. Reg. at 54,466; Letter from Jack Herstein, President, N. Am. Sec. Administrators Ass'n, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 4 (July 3, 2012), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/Initial-NASAA-Comments-to-SEC-re-JOBS-Act-Rulemaking.pdf (recommending that the filing of a Form D prior to the use of general solicitation be a requirement of the exemption because, without such a filing requirement, regulators would "have no way of knowing whether a promoter is legitimately trying to comply with Rule 506, so a fraudulent offering will be allowed to continue until the regulators have gathered sufficient evidence to prove fraud has already occurred"); Letter from Bryan J. Lantagne, Dir., Mass. Sec. Div., to Nancy M. Morris, Sec'y, Sec. Exch. Comm'n 4 (Sept. 7, 2007), *available at* http://www.sec.gov/comments/s7-12-07/s71207-11.pdf (asking that the Commission "make the filing of a Form D a condition of the availability of the Regulation D exemptions").

142 *See* Letter from Mercer Bullard, President, Fund Democracy, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Aug. 16, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf; Letter from Jack Herstein to Elizabeth M. Murphy, *supra* note 141, at 4.

143 *See* Letter from Jack Herstein to Elizabeth M. Murphy, *supra* note 141, at 4, 10 (proposing that advertising materials used in Rule 506 offerings should include a "'balanced presentation of risks and rewards' and a requirement that statements in advertisng are consistent with representations in the offering documents"); Letter from Andrea L. Seidt, Comm'r, Ohio Div. of Sec., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 3 (July 3, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-38.pdf ("[T]he Commission should consider adopting a uniform set of required disclosures and content restrictions for general advertising and general solicitation [materials] . . . . [such as] a required legend disclosing those jurisdictions where the offering is being made (and disclaiming sales in any others). Financial projections or statements of future performance should be prohibited.").

144 Section 413(a) of the Dodd–Frank Act required the SEC to amend Rule 501(a)(5) of Regulation D, 17 C.F.R. § 230.501(a)(5), to exclude the value of the primary residence in determining accredited investor status of natural persons based on the $1,000,000 minimum net worth criterion. This provision further stated that, "during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person." Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010). Section 413(b) of the statute authorized the SEC to undertake a review of the definition of the term "accredited investor" as it applies to natural persons, and required the SEC to undertake a review of the definition in its entirety every four years, beginning four years after the Dodd–Frank Act's enactment. *Id.* § 413(b), 124 Stat. at 1577–78. The SEC has taken the position that these provisions have restricted its authority to update or otherwise modify its regulatory definitions of accredited investors under Regulation D prior to July 10, 2014. *See* Net Worth Standards for Accredited Investors, Securities Act Release No. 9287, Investment Company Act Release No. 29,891, 76 Fed. Reg. 81,793, 81,795 (Dec. 29, 2011) (to be codified at 17 C.F.R. pts. 230, 239, 270 & 275). After the JOBS Act was enacted, the SEC's General Counsel and staff have continually interpreted away the SEC's authority to update or otherwise revise its regulatory definition of "accredited investors." Interview with Barbara Roper, Dir. of Investor Prot., Consumer Fed'n of Am., in Washington, D.C. (Jan. 29, 2013). However, even by its own strained interpretation, the SEC's full authority to act reblossoms on July 10, 2014. *See* Net Worth Standards for Accredited Investors, Securities Act Release No. 9287, Investment Company

other suggestions in amendments to Regulation D proposed on the same day that it adopted its final rule lifting the ban on general solicitation.[145] The SEC acknowledged that its adoption of Rule 506(c) permitting general solicitation did carry substantial risks, as expressed by commentators, and that Rule 506(c) offerings "would attract both accredited and non-accredited investors and could result in an increase in fraudulent activity in the Rule 506 market, as well as an increase in unlawful sales of securities to non-accredited investors."[146] It agreed that providing additional protections for investors would actually improve its ability to evaluate the development of the new market for generally solicited private offerings and to address investor protection concerns.[147] Accordingly, instead of incorporating the various suggested safeguards into its final Rule 506(c), the SEC opted in favor of releasing proposed amendments for public comments.

The SEC's proposed rules, now awaiting either promulgation or abandonment, include six basic amendments relating primarily to the new marketplace for "public" private offerings of securities:

> (1) Issuers proposing to sell securities under the Rule 506(c) exemption would be required to file an "Advance Form D" at least fifteen calendar days before engaging in general solicitation, an amended Form D within fifteen days after the first sale, and a closing amendment to that Form D within thirty days after completion of the offering disclosing the total amount sold during the offering.[148] Unlike the present requirement that a Form D be filed within fifteen days after the first sale,[149] the Advance Form D would provide regulators a significant opportunity for presale review. Similar to the present Form D, the Advance Form D would require basic identifying information about issuers, the location of its principal place of businesses, contact persons, related persons, industry groups, the exemption claimed, whether the filing is new or an amendment, the types of securities offered, whether the offering relates to a business combination, sales compensation, and use of proceeds for payments to affiliates.[150] After the first sale, issuers would have to file an amendment containing the remaining information required by Form D with more

Act Release No. 29,891, 76 Fed. Reg. at 81,795.

145 Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 & 239).

146 *Id.* at 44,807.

147 *See id.* at 44,811.

148 *Id.* at 44,810–12.

149 17 C.F.R. § 230.503(a) (2013).

150 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,811.

expansive content requirements (although this could be obviated by providing this information in the Advance Form D).[151] In addition, issuers relying on either Rule 506(b) or Rule 506(c) would be required to file a final or "closing" amendment within thirty calendar days after termination of the offering, [152] in effect reviving a filing requirement imposed by Regulation D at the time of its original adoption.[153] The requirement of a closing amendment would be, of course, in addition to existing provisions of Rule 503[154] that require amendments to correct material misstatements in previously filed Form Ds.[155] The SEC stated that its proposed reimposition of the closing amendment was now warranted by the considerable growth of the Regulation D market in recent years and its own enhanced electronic surveillance capabilities.[156]

(2) Acknowledging that Form Ds, as electronically filed with the SEC, serve as an important source of information for investors and state and federal regulators, the SEC determined that Form Ds content should be more expansive.[157] Under its proposed rule, issuers in Rule 506 offerings would be required to disclose—among other things—their websites, controlling persons, more detailed information on use of offering proceeds, more detailed information on the types of accredited and non–accredited investors, whether general solicitation materials were filed with FINRA, information on promoters in pooled investment fund offerings, the types of general solicitation, and the accredited investor verification methodology used in Rule 506(c) offerings.[158]

(3) Issuers in Rule 506 offerings who have failed to comply with Form D filing requirements at any time within the previous five years would be *automatically disqualified* from using Rule 506 in any new offering for a period of one year, commencing after the filing of all required Form D filings.[159] This disqualification is in addition to the present Rule 507 disqualification, applicable to all Regulation D offerings, that arises from

151 *Id.* at 44,811 & n.45.

152 *Id.* at 44,812.

153 The requirement of a closing amendment was previously eliminated by the SEC in 1986 on the grounds that the initial Form D filing provided sufficient information for the SEC's enforcement surveillance. Form D and Regulation D, Securities Act Release No. 6663, 51 Fed. Reg. 36,385 (Oct. 10, 1986) (to be codified at 17 C.F.R. pts. 230 & 239).

154 17 C.F.R. § 230.503.

155 Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,812–13.

156 *Id.* at 44,813.

157 *Id.* at 44,814.

158 *Id.* at 44,815–16.

159 *Id.* at 44,817–18.

any injunction against an issuer for violating the filing requirements.[160] The SEC explained in its proposing release that it had considered, but rejected, restoring the filing of Form Ds as a condition to use of the exemption on the grounds that is would be too severe a sanction.[161] The loss of the exemption, according to the SEC, "would give purchasers rescission rights and result in the loss of 'blue sky' preemption."[162] In its view, the one-year disqualification period "should create a significant incentive to file Form D on a timely basis without unduly burdening market participants."[163] Moreover, the five-year look-back period would only apply to non-compliance that occurs after the effective date of the proposed rule.[164] In addition, the proposed rule provides for a thirty-day cure period to prevent disqualification as a result of inadvertent technical errors, but it would only apply to the first failure to timely file the Form D in a particular offering and, accordingly, issuers would not be permitted to repeatedly rely on the cure period throughout an offering.[165] The proposed rule also would grant the SEC authority to waive disqualification upon a showing of good cause.[166]

(4) Issuers utilizing the noisy Rule 506(c) would be subject to new Rule 509 of Regulation D requiring legends in any written general solicitation materials and additional disclosures for private fund issuers whose materials include performance data.[167] The mandated legends include the following:

> (a) The securities may be sold only to accredited investors, which for natural persons, are investors who meet certain minimum annual income or net worth thresholds;
>
> (b) The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;

160 *Id.* at 44,817.

161 *Id.* at 44,818.

162 *Id.*

163 *Id.*

164 *Id.* at 44,819.

165 *Id.*

166 *Id.* at 44,819–20.

167 *Id.* at 44,821.

> (c) The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;
>
> (d) The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and
>
> (e) Investing in securities involves risk, and investors should be able to bear the loss of their investment.[168]

The SEC's intent in prescribing these legends is to "better inform potential investors as to whether they are qualified to participate in Rule 506(c) offerings and certain potential risks that may be associated with such offerings."[169] The proposed rule would require private fund issuers to include legends disclosing that

> performance data represents past performance; past performance does not guarantee future results; current performance may be lower or higher than the performance data presented; the private fund is not required by law to follow any standard methodology . . . and [that performance] may not be directly comparable to the performance of [other funds].[170]

The proposed rule would also amend Rule 507(a) to render the Rule 506 exemption unavailable to issuers who have been enjoined for noncompliance with the new Rule 509.[171]

(5) Rule 156, which provides guidance on the types of information in investment company sales literature that could be materially misleading under federal securities antifraud provisions, would be amended to apply to the sales literature used by private funds, whether or not they are engaged in general solicitation.[172]

(6) New temporary Rule 510T of Regulation D would require that issuers file, through the SEC's intake page on its website, all written general solicitation materials prepared by or on behalf of the issuer no later than the date of first use of these materials.[173] These submissions, which the SEC will require for two years in connection with its evaluation of market practices in the new Rule 506(c) marketplace, will not be treated as being "filed" or "furnished" for purposes of the federal

168 *Id.* at 44,821–22.

169 *Id.* at 44,822.

170 *Id.* at 44,822–23.

171 *Id.* at 44,283.

172 *Id.* at 44,825.

173 *See id.* at 44,828–29.

securities laws and their liability provisions.[174] Noncompliance would be treated similarly as failure to use the proposed mandated legends and, accordingly, issuers would be precluded from their use of the Rule 506 exemption if subject to an injunction for failure to comply.[175]

In addition to the proposed amendments, the SEC has requested comments on whether the accredited investor definitions of Rule 501, as they relate to natural persons presently accredited by income and net worth criteria, should be revised.[176] As previously noted, the SEC made it's request pursuant to Section 413(b) of the Dodd–Frank Act requiring the SEC's quadrennial review of this definition.[177] That Act also required the Government Accountability Office (GAO) to complete a study, which has been recently released, addressing alternative criteria for qualifying as an accredited investor.[178] The SEC has also requested comments regarding whether, as a condition to use of Rule 506(c), issuers should be required to provide a formal disclosure document or private placement memoranda containing specified information to all purchasers prior to any sales of securities.[179] Lastly, the SEC has requested comments regarding whether reporting companies under the 1934 Act should be precluded from use of the Rule 506(c) exemption if they have not timely filed all required periodic reports.[180]

The SEC, given Congress's mandate in Title II of the JOBS Act to adopt rules permitting unregistered, generally solicited, private offerings to accredited investors, had no choice but to adopt Rule 506(c). The proposed amendments clearly evidence the SEC's intent to ameliorate the rule's potentially disastrous impact on individual retail investors. They also reflect serious concerns expressed by NASAA and other investor protection advocates.[181] Although these proposals do not go as far as investor advocates recommended, they would provide considerable protection and would better enable state and federal regulators to engage in *early stage* review of these "public" private offerings. In promulgating these amendments, the SEC appears to have also been influenced by the recommendations made by the SEC's Investor Advisory Committee (IAC), established by Section 911 of the Dodd–Frank Act to advise

174 *Id.* at 44,828.

175 *Id.*

176 *Id.* at 44,829–30.

177 *See supra* note 144 and accompanying text; *see also* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 413(b), 124 Stat. 1376, 1577–78 (2010).

178 *See* Dodd–Frank Wall Street Reform and Consumer Protection Act § 415, 124 Stat. at 1578; GAO ALTERNATIVE CRITERIA, *supra* note 20.

179 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806, 44,830.

180 *See id.*

181 *See id.* at 44,807 n.18.

the SEC on regulatory priorities, investor protection and market integrity, among other things.[182] Shortly after the SEC proposed Rule 506(c), the IAC submitted its recommendations to the SEC, setting forth seven proposals both to improve investor protections and to enhance the abilities of state and federal regulators to police the new Rule 506(c) marketplace.[183] Most, but not all, of the IAC's proposals are reflected either in the SEC's final Rule 506(c) or in the SEC's proposed amendments. They include the following:

(1) IAC's first recommendation was that the SEC require Rule 506(c) issuers to file an advance notification, either a new "Form GS" or a revised Form D, before commencement of an offering and as a precondition for claiming the exemption.[184] The content of the revised form would include, among other disclosures, the identities of the issuer's control persons, lawyers and accountants, the amount to be raised, a description of the issuer's general solicitation plans, a description of the issuer's business plans, and use of proceeds.[185] This IAC recommendation has largely been incorporated in the SEC's pending proposed amendments as Advance Form D.[186]

(2) IAC's second recommendation was that the SEC require that Rule 506(c) issuers file, as a *condition* to claiming the exemption, their general solicitation materials with the SEC through an online, electronic "drop box" before first use of that material.[187] The SEC would use these submissions to monitor the types of solicitations being used by issuers and to identify potential fraud.[188] By making these materials publicly

182 *See id.*

> The [SEC Investor Advisory Committee (IAC)] was established in April 2012 pursuant to Section 911 of the Dodd-Frank Act to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the [IAC] to submit findings and recommendations for review and consideration by the Commission.

Id.

183 *See* INVESTOR ADVISORY COMM., U.S. SEC. & EXCH. COMM'N, RECOMMENDATIONS OF THE INVESTOR ADVISORY COMMITTEE REGARDING SEC RULEMAKING TO LIFT THE BAN ON GENERAL SOLICITATION AND ADVERTISING IN RULE 506 OFFERINGS: EFFICIENTLY BALANCING INVESTOR PROTECTION, CAPITAL FORMATION AND MARKET INTEGRITY (2012) [hereinafter IAC RECOMMENDATIONS], *available at* http://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-general-solicitation-advertising-recommendations.pdf.

184 *Id.* at 2.

185 *Id.*

186 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806, 44,810-12.

187 IAC RECOMMENDATIONS, *supra* note 183, at 2.

188 *Id.* at 2-3.

available on a timely basis, the SEC could *crowdsource* the public's ability to inform the SEC of potential frauds.[189] The SEC has proposed a new Rule 510T requiring issuers to file general solicitation materials for a two-year evaluation period.[190]

(3) IAC's third recommendation was that the SEC require that Rule 506(c) impose clear and enforceable standards for *verification* of accredited investor status, as opposed to Rule 506(b)'s traditional "reasonable belief" standard, including standards that would promote reliance on lawyers, broker-dealers, accountants, and other reliable forms of third party verification.[191] The SEC has, in essence, promulgated this IAC proposal in its new Rule 506(c).[192]

(4) IAC's fourth recommendation was that the SEC require the filing of Form D as a *condition* to an issuer's reliance on any Regulation D exemption, whether under Rules 504, 505, or 506(b) and (c).[193] The IAC noted that "[i]t is generally acknowledged that a significant number of issuers do not currently file Form D, depriving the Commission of important information and inhibiting its ability to provide effective market oversight."[194] The SEC, for now, has rejected this recommendation, and has stated in its proposed amendments that the consequences of adopting the recommendations would be unduly burdensome.[195]

(5) IAC's fifth recommendation was that the SEC take steps to ensure that past performance claims used in general solicitation materials be based on auditable standards.[196] The IAC believed the SEC should designate the appropriate standards from private sector standards

189 *Id.*

190 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,828–29.

191 *See* IAC RECOMMENDATIONS, *supra* note 183, at 3.

192 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771, 44,776, 44,778–79 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

193 *See* IAC RECOMMENDATIONS, *supra* note 183, at 3.

194 *Id.*

195 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,818. It should be recognized that absent a mandatory filing requirement, there are insufficient means for effectively policing the bad actor rule.

196 *See* IAC RECOMMENDATIONS, *supra* note 183, at 4.

already applied in order to minimize compliance costs.[197] The SEC has responded in its proposed amendments that it would be sufficient to disclose that private funds are not required to follow any particular standards.[198]

(6) IAC's sixth recommendation was that the SEC amend the definition of accredited investors pertinent to natural persons "to better reflect a population that has the financial sophistication to analyze the risks in private offerings."[199] The IAC criticized the reliance exclusively on wealth and income tests because of their invariance to an investor's actual financial sophistication.[200] In its view, adding some form of purchaser suitability criterion is "essential in the absence of the procedural protections afforded by the general solicitation and advertising ban."[201] The SEC, in its recent release proposing further amendments to Rule 506, has requested comments on the present accreditation criteria.[202]

(7) IAC's seventh recommendation was that the SEC fulfill its congressional mandate under Section 926 of the Dodd–Frank Act by promulgating a rule disqualifying felons and other "bad actors" from relying on any Rule 506 exemption, and to do so in conjunction with the SEC's promulgation of Rule 506(c).[203] The SEC clearly agreed with this recommendation and promulgated new Rule 506(d) disqualifying provisions on the same day it promulgated Rule 506(c) permitting generally solicited private offerings.[204]

The IAC's recommendations will remain influential as the SEC reviews the public comments on its proposed amendments to provide additional investor protections for investors in the context of generally solicited private offerings under Rule 506(c). In the meantime, however, issuers have been allowed to

197 *See id.*

198 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,822–23.

199 IAC RECOMMENDATIONS, *supra* note 183, at 4.

200 *Id.*

201 *Id.*

202 *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,829–30. *See generally* GAO ALTERNATIVE CRITERIA, *supra* note 20 (explaining why the SEC should change its accreditation methodologies).

203 *See* IAC RECOMMENDATIONS, *supra* note 183, at 4.

204 17 C.F.R. § 230.506(d) (2013); *see* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239).

proceed with offerings that do not have these additional protections. Based on my review of public comments to date and discussions with regulators and others close to the process, I am certain that the SEC's proposed amendments will not enjoy clear sailing to adoption. Rule 506(c) offerings may well proceed for a considerable period of time before any additional protections are afforded to investors. For now, state regulatory authorities are forced to cope with the regulatory playing field as it is. In the following section of this Article I suggest several approaches the states should consider in their continuing efforts to fulfill their mission.

II. The Role of the States in Regulating Rule 506 Offerings

The regulatory context for private offerings of securities has radically evolved from an initial context in which state legislatures had the option to provide presale review of securities offerings through registration and exemptive schemes that were complemented by investor protection safeguards. In this initial context, states could also engage in post–sale enforcement against those who participated in fraudulent offerings. The SEC, at the federal level, had no regulatory discretion with respect to the registration option since Congress exempted private offering transactions from registration before the SEC was even established.[205] The SEC could, of course, create a Section 4(a)(2) regulatory safe harbor, which it did in 1982 with its promulgation of Rule 506. In doing so, it positioned itself to provide presale review, at least theoretically, because Rule 506 has always set forth substantive restraints on issuers that would rely on the exemption, including imposition of a Form D filing requirement. However, as a matter of practice, the SEC has elected not to monitor Form D filings with respect to any of the Regulation D exemptions or to otherwise spot check these offerings to ensure compliance with the substantive conditions of Rule 506.[206] Moreover, the SEC, as a matter of practice, has not for the most part focused its enforcement efforts on private offerings in general, including those under Rule 506 but, instead, has tended to pursue grander, more noteworthy targets. Its chosen path is obviously consistent with its role as the nation's central authority over national securities markets, enforcing the federal securities laws against celebrities and other high profile individuals, like Martha Stewart[207] and Mark Cuban,[208] for prophylactic effect, and rarely pursuing the issuers and

205 *See* Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012).

206 *See* Office of Inspector Gen., U.S. Sec. & Exch. Comm'n, Rep. No. 459, Regulation D Exemption Process 8 (2009) [hereinafter OIG Report], *available at* http://www.sec.gov/about/offices/oig/reports/audits/2009/459.pdf.

207 *See generally* Joan MacLeod Heminway, *Martha Stewart and the Forbidden Fruit: A New Story of Eve*, 2009 Mich. St. L. Rev. 1017, 1024–25; Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 Lewis & Clark L. Rev. 1, 2 (2006); Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 Cardozo L. Rev. 2023, 2025 (2005).

208 *See* Complaint at 1–2, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08–

promoters of private offerings far off its regulatory radar screen. Unlike state securities regulators, the SEC's enforcement personnel have never assumed roles as local cops on the beat in American communities.

The states, in exercising their regulatory options, have generally determined not to provide presale review through registration of offerings exempt from federal registration under Section 4(a)(2) or Regulation D, as historically demonstrated by their state level private offering exemptions and by their successful efforts in coordinating those exemptions with the federal exemptive scheme. Most states have adopted NASAA's Uniform Limited Offering Exemption (ULOE), exempting private offerings from their own registration schemes if those offerings are compliant with the collective requirements of Regulation D and certain additional conditions.[209] According to two prominent securities scholars, this has "eliminate[ed] duplicative regulation of small issuers at the state level."[210]

The states, rather than effecting regulation through registration, embarked instead on providing presale review by monitoring their own exemptive schemes to ensure compliance by issuers from the earliest stages of their offerings. When, as a result of NSMIA, issuers began routing virtually all of their private offerings through Rule 506, this option was severely curtailed. Since 1996, the states can no longer coordinate or structure their own exemptive schemes to impose qualitative restrictions on issuers, including bad actor disqualification, investor suitability criteria, additional disclosures, or any other measures for the protection of investors. As previously discussed, the states were positioned only to review Form D notice filings, which provide limited content for review, assuming issuers actually filed them at all. Even then, Rule 506 required only that those notices be filed with the SEC within two weeks of the first sale of securities anywhere and, under most state schemes, within two weeks after the first sale in their respective states. In addition to monitoring these Form Ds, states were positioned to monitor local media and other communications and issue ease and desist orders where general solicitation was found since before implementation of Title II of the JOBS Act, any general solicitation voided the Rule 506 exemption and its preemptive effect.[211] Now that the SEC has

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CV-2050-D), *available at* http://www.sec.gov/litigation/complaints/2008/comp20810.pdf. After a three-week trial before a federal jury in Dallas, Texas, Cuban was found not guilty of insider trading. *See* Cuban, Litigation Release No. 22,855, 2013 WL 5741341 (Oct. 23, 2013); *see also* Dina ElBoghdady, *Dallas Billionaire Mark Cuban Cleared of Insider Trading Charges*, WASH. POST (Oct. 16, 2013), http://washingtonpost.com/business/economy/dallas-billionaire-mark-cuban-cleared-of-insider-trading-charges/2013/10/16/108fbea4-36a0-11e3-80c6-7e6dd8d22d8f_story.html.

209 *See* Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1320 & n.9 (1990).

210 JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 352 (12th ed. 2012).

211 According to Hugh H. Makens, a prominent securities lawyer and former state regulator, "the easiest way to lose the Rule 506 preemption is to conduct general advertising or solicitation." Hugh H. Makens, *Blue Sky Practice - Part I: Doing It Right: Avoiding Liability Arising from State Private Offerings under Uloe and Limited Offering Exemptions*, SL075 A.L.I.-A.B.A. Course of

promulgated Rule 506(c), general solicitation no longer triggers failure to register violations under state law. According to one regulator, those fairly easy cease and desist orders will no longer be available: "Our enforcement tools are taken away at the very time the target audience, including the likely victims, has been vastly expanded."[212] State regulators, as the only governmental gatekeepers on the scene, have been severely restrained.

Gatekeepers in the private sector, particularly reputable securities lawyers and broker–dealers, may have also been marginalized. Securities firms who regularly represent both established and startup issuers in conducting private offerings generally do not engage in private offerings directed at non–accredited investors.[213] Similarly, these lawyers have shown little receptivity to generally solicited offerings to accredited investors.[214] First, most securities lawyers believe it is not beneficial to their clients' interests to recruit anonymous accredited investors through general solicitation or otherwise.[215] Indeed, most securities lawyers tend to be very cautious about investors who may have the money but have little experience in making money and losing money in private equity deals.[216] Clearly, the "previously existing substantive relationship" requirement that has been at the regulatory core of the general solicitation conundrum also is a vital factor for most startup businesses in assessing which investors will be appropriate owners of the new enterprises.[217] Second, because of sticker shock over the legal fees attendant to *bona fide* private placements, potential clients—not infrequently—decide on do–it–yourself offerings at venture capital clubs and other locales.[218] Third, securities lawyers are known to diligently screen their clients to eliminate those with adverse histories, independent of bad actor rules and due diligence obligations, as a matter of risk management responsibility to their firms.[219] Legitimate issuers, having been thoroughly vetted by their securities counsel, often have access to established local accredited investors who are unlikely to be problematic owners regardless of whether the venture fails to meet expectations. Consequently, many issuers who determine to generally solicit anonymous accredited investors through various media will not retain competent securities counsel. Accordingly, lawyers, as gatekeepers,

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Study 549, 560 (2006).

212 *See* Interview with Chad Harlan, Certified Fin. Insts. Exam'r, Sec. Div., Ky. Dep't. of Fin. Insts., Harlan, Ky. (Sept. 18, 2013).

213 *See* Interview with Rick G. Alsip, Partner, Wyatt Tarrant & Combs, Louisville, Ky. (Sept. 19, 2013); Interview with Carolyn L. Duncan, Partner, Cabaniss, Johnston, Gardner, Dumas & O'Neal, LLP, Birmingham, Ala. (Sept. 10, 2013).

214 *See* Interview with Carolyn L. Duncan, *supra* note 213.

215 *See id.*

216 *Id.*

217 *See id.*

218 *See id.*

219 *Id.*

may not be there to filter a large proportion of the Rule 506(c) offerings to come.

Broker–dealers are even more unlikely participants in the coming wave of generally solicited private offerings. According to a recent study, only 13% of all Regulation D offerings involved financial intermediaries and a large portion of those were real estate issuers.[220] Moreover, during the past three years, FINRA has become incensed at firms in the securities industry that have only paid lip service to FINRA's suitability[221] and "know your customer" rules.[222] FINRA warned broker–dealers over three years ago that failure to comport with these obligations could constitute not only a violation of FINRA rules but also a violation of state and federal securities antifraud provisions.[223] In addition, FINRA in late 2012 adopted Rule 5123, which requires broker–dealers to file copies of any private placement memoranda, term sheets, and other offering documents used in exempt private offerings of securities.[224] FINRA has recently augmented Rule 5123 by imposing an updated Private Placement Form that must be filed with FINRA in connection with firms' participation in private placements.[225] Clearly, FINRA has become intolerant of abuse in this area in the wake of several significant scandals.[226] Broker–dealer firms have long shied away from engagement in small scale private offerings, if only because the revenue to be derived from their participation was disproportionately low relative to the due diligence costs involved. Now, under intense FINRA scrutiny, it is even less likely that reputable broker–dealers will be involved in the vast majority of Rule 506(c) offerings now on the horizon. To some degree,

220 DERA 2013 STUDY, *supra* note 82, at 16.

221 *See* FIN. INDUS. REG. AUTH., FINRA RULES R. 2111, *in* FINRA MANUAL (Wolters Kluwer 2014), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (explaining that firms and associated persons have a reasonable basis to believe that a recommended security action is suitable for a customer).

222 *See* FIN. INDUS. REG. AUTH., FINRA RULES R. 2090, *in* FINRA MANUAL, *supra* note 221, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858 (requiring "reasonable diligence" in knowing "essential facts concerning every customer").

223 *See* FIN. INDUS. REG. AUTH., REGULATORY NOTICE 10–22, OBLIGATION OF BROKER–DEALERS TO CONDUCT REASONABLE INVESTIGATIONS IN REGULATION D OFFERINGS 1 (2010), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_10–22.pdf.

224 *See* FIN. INDUS. REG. AUTH., REGULATORY NOTICE 12–40, SEC APPROVES NEW FINRA RULE 5123 REGARDING PRIVATE PLACEMENTS OF SECURITIES 1 (2012), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_40.pdf.

225 *See* Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Members' Filing Obligations Under FINRA Rule 5123 (Private Placement of Securities), Exchange Act Release No. 69,843, 78 Fed. Reg. 39,367 (July 1, 2013).

226 *See* News Release, Fin. Indus. Reg. Auth., FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation (Nov. 29, 2011), *available at* http://www.finra.org/Newsroom/NewsReleases/2011/P125193.

regulatory scrutiny may have served, ironically, to sideline broker–dealers as gatekeepers in the new marketplace for generally solicited private offerings.

Consequently, state regulators are likely to bear the laboring oar in the protection of investors and their private offering marketplace. NASAA and other investor advocacy groups were unable to secure repeal of NSMIA's inclusion of Rule 506 securities as covered securities in the Dodd–Frank Act.[227] They were equally unsuccessful in trying to prevent the mutation of the Rule 506 exemption into both a public and private offering exemption as a result of the JOBS Act.[228] At this point in the course of events one can only hope against hope that investor advocates will prevail in securing adoption of the SEC's proposed amendments to Regulation D. Certainly, the state regulators' missions would be facilitated by adoption of the Advance Form D, requiring presale filings with the SEC and the states before generally solicited offerings under Rule 506(c) are commenced, and by adoption of enhanced Form D content requirements. In my view, it is highly unlikely that proposed Rule 510T (temporarily requiring filing of written general solicitation materials with the SEC) or the proposed prescription of mandatory legends will survive the regulatory process. NASAA and state regulatory agencies, despite only glimmers of hope, should continue to vigorously support the IAC recommendations and the SEC's proposed amendments. Regardless of whether those efforts succeed partially or not at all, NASAA and the states should continuously pursue a number of regulatory goals and strategies. Until they are better politically positioned to secure an improved state and federal regulatory structure, one that better allocates state and federal regulatory competencies and interests, state regulators should dedicate themselves to early stage enforcement of both Rule 506(b) and Rule 506(c) federal regulatory requirements, as amplified by the SEC's adoption of Rule 506(d)'s bad actor disqualification provisions.[229]

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227 NASAA "vigorously campaigned" for provisions that would repeal section 18(b)(4)(D) of the 1933 Act, as added by NSMIA, which designated securities offered under the Rule 506 exemption as "covered securities," and, accordingly, free of any presale review by state securities regulators. *See* Alan M. Parness, *From the Chair – Random Rants and Raves*, BLUE SKY BUGLE (ABA Section of Bus. Law, Chi., Ill.), Apr. 2011, at 1, 1–2, *available at* apps.americanbar.org/buslaw/committees/CL680000pub/newsletter/201104/201104.pdf. State regulators enthusiastically supported later stripped provisions in Section 928 of the proposed Dodd–Frank Act which would have reinstated the presale authority of state regulators over Rule 506 offerings. *See Current Investigations into the Financial Crisis: Hearing Before the U.S. Fin. Crisis Inquiry Comm'n*, 1st Public Hearing 19 (Jan. 14, 2010) (statement of Denise Voight Crawford, Comm'r, Texas Securities Board, President, N. Am. Sec. Administrators Ass'n), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0114-Crawford.pdf. Their efforts were premised largely on the "steady and significant rise in the number of offerings made pursuant to Rule 506 that are later discovered to be fraudulent." *Id.* at 18.

228 Gary J. Simon et al., *SEC Amends Rule 506 to Permit General Solicitation in Securities Offerings*, MONDAQ (Sept. 25, 2013), http://www.mondaq.com/unitedstates/x/264860/Securities/SEC+Amends+Rule+506+To+Permit+General+Solicitation+In+Securities+Offerings.

229 *See generally* ENFORCEMENT SECTION, N. AM. SEC. ADMINISTRATORS ASS'N, NASAA ENFORCEMENT REPORT 11 (2012), *available at* http://www.nasaa.org/wp-content/

Despite the severe federal statutory and regulatory handicaps that Congress has imposed on the states, their securities regulatory authorities have developed a remarkable record in addressing financial misconduct in their respective jurisdictions. In its 2012 Enforcement Report, NASAA reported that state securities regulators conducted over 6121 investigations in 2011, resulting in 2602 criminal, administrative, and civil enforcement actions, and 1662 years of prison time for convicted perpetrators of securities law violations.[230] State securities authorities levied fines and penalties of $290 million and their enforcement actions resulted in more than $2.2 billion in investor restitution orders.[231] The vast majority of investment fraud cases involved unregistered individuals offering and selling unregistered securities in private placements, with abusive Rule 506 offerings being the most reported financial misconduct.[232] The report demonstrates that "[i]nvestors continue to rely upon state securities regulators."[233] According to Commissionr Abshure, this reliance is, "if for no other reason, because no other regulator is going to act to protect hometown investors."[234]

These achievements, however noteworthy, have taken place in a securities marketplace that was limited to offerings that could not be widely publicized under the quiet Rule 506(b). State securities regulators have no experience with the new marketplace that has begun to evolve following the SEC's implementation of Title II of the JOBS Act. Securities offerings that are compliant or noncompliant with noisy Rule 506(c), fraudulent and non-fraudulent, are about to emanate from all over the world, from the bogus oil and gas operator in a small corner of Tennessee, to Internet boiler rooms rented in the Ukraine. These offerings will target as offerees, accredited and non-accredited alike, the entire populations of the respective states. Obviously, state regulation of these purportedly exempt offerings will evolve, to a large extent, by trial and error. No one is really positioned to prophesy. In the next section of this Article, I offer only a few suggestions as *next steps* the states might consider in the evolution of their regulatory schemes to protect their investors from the onslaught now underway.

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uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf (explaining state enforcement efforts targeting securities violations).

230 *Id.* at 3.

231 *Id.*

232 *Id.* at 3, 11.

233 *Id.* at 5.

234 A. Heath Abshure, Comm'r, Ark. Sec. Comm'r, 2012 NASAA Presidential Address at the NASAA 95th Annual Conference (Sept. 11, 2012), http://www.nasaa.org/15315/2012-nasaa-presidential-address-a-heath-abshure-arkansas-securities-commissioner/.

III. Recommendations to the States in Regulating Rule 506 Offerings

State regulatory authorities, with the advent of Rule 506(c)'s exemption for publicly offered private placements, will be more challenged than ever as they undertake their mission to protect local investors in a drastically enlarged marketplace. As I have suggested previously, state regulators should first position themselves as the primary governmental agencies for the enforcement of Rule 506's regulatory restraints, as set forth in the dual Rule 506 exemptions, and as the primary antifraud task forces in the fight against fraudulent private offerings.[235] This will require a more universal and uniform review of the Form Ds filed by issuers in Rule 506 offerings, including the thoughtful development of Form D review guidelines. They should augment their mission through implementation of NASAA's long–envisioned Electronic Form D Depository, as I have previously suggested.[236] Last, NASAA should consider the development of a centralized "bad actor" database (BAD) to provide accessible information about the adverse regulatory histories of issuers and their promoters, thereby providing a "best practices" mechanism for the *factual inquiry* necessary to avoid disqualification of Rule 506 private offerings.[237] These recommendations, even assuming their implementation, will hardly fill the regulatory gap that leaves both quiet and noisy Rule 506 private offerings largely unregulated, particularly in their early stages, but they may present a constructive starting point from which the states can move forward.

A. Enhanced Scrutiny of Rule 506 Offerings

Many states are already engaged in a fairly thorough review of the Form D notices that are filed in their respective jurisdictions. Other states apparently

235 *See* Warren, *Reallocation*, *supra* note 35, at 507–12.

236 *See id.* at 510–11 (recommending, almost fifteen years ago, that the states develop a web–based central notification depository for Form Ds, available to both regulators and the investors they protect); *see also infra* Part III.B.

237 *See infra* notes 300–20 and accompanying text. As the SEC has acknowledged, a bad actor database that correlates to the covered persons and disqualifying events prescribed in Rule 506(d) does not exist. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239). Issuers and their counsel, in the absence of a comprehensive database that actually covers the various data points established by the rule, will be hard pressed to demonstrate their reasonable belief that no bad actors are involved in their offerings. If due diligence regarding the required bad actor certification is simply impossible because no rationally related search can be done, then they will be equally hard pressed to prove "reasonable care." Their "factual inquiries" are likely to take the form of self–certification through bad actor "disqualification event" questionnaires, hardly comporting with professional standards of objective due diligence. Rule 506(d), as it stands, asks issuers and their counsel to embark on an impossible task. *See id.* at 44,733, 44,746, 44,750. The essential functioning of the rule and fulfillment of its underlying regulatory policy requires the development of a comprehensive and continuously updated bad actor database.

are not so engaged, presumably because of the *preemptive aura* that surrounds Rule 506 covered securities. As I have previously concluded, however, NSMIA perceptions are not necessarily NSMIA reality.[238] As amended by NSMIA, Section 18(a) of the 1933 Act prohibits the states from requiring registration of Rule 506 covered securities, from adding their own conditions on offering documents, and from imposing merit-based standards.[239] Neither this provision nor any other in the 1933 Act restricts the states from making their own determinations, based on their independent review of Form Ds or through the exercise of their general investigatory powers, as to whether a purported Rule 506 offering is *actually compliant* with the applicable restrictions in Regulation D. If it is not, then the nominal Rule 506 offering may not be a lawfully exempt offering under Rule 506, and thus the securities offered would not be covered securities and the states would not be proscribed from applying their own registration and exemptive schemes. Should a state determine that a given private offering, although labeled a Rule 506 offering by the issuer, is not compliant, then the burden falls on the issuer to prove that it is. The vast majority of judicial decisions have held that an issuer's merely purporting to rely on Rule 506 does not result in the preemption of state law. As the Alabama Supreme Court held in *Buist v. Time Domain Corp.*,[240] the issuer of the subject securities always has the burden of proof on both the affirmative defense of preemption and on any claims of exemption from state and federal registration

238 *See* Warren, *Essay on Rule 506*, *supra* note 25, at 14.

239 Section 18(a) of the 1933 Act provides:

> SCOPE OF EXEMPTION – Except as otherwise provided in this section, no law, rule, regulation, or order or other administrative action of any State or any political subdivision thereof–
>
> (1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that–
>
> (A) is a covered security; or
>
> (B) will be a covered security upon completion of the transaction;
>
> (2) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of–
>
> (A) with respect to a covered security described in subsection (b), any offering document that is prepared by or on behalf of the issuer; or
>
> (B) any proxy statement, report to shareholders, or other disclosure document relating to a covered security or the issuer thereof that is required to be and is filed with the Commission or any national securities organization registered under section 15A of the Securities Exchange Act of 1934, except that this subparagraph does not apply to the laws, rules, regulations, or orders, or other administrative actions of the State of incorporation of the issuer; or
>
> (3) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of any security described in paragraph (1).

Securities Act of 1933 § 18(a), 15 U.S.C. § 77r(a) (2012).

240 Buist v. Time Domain Corp., 926 So. 2d 290 (Ala. 2005).

requirements.[241] The terms "preemption" and "exemption" are, in the court's words, "functionally equivalent."[242] The Sixth Circuit in *Brown v. Earthboard Sports USA, Inc.*[243] has observed that "[n]owhere does the statute indicate that a security may satisfy the definition [of a covered security] if it is sold pursuant to a *putative* exemption."[244] The court explained that "[i]f Congress had intended that an offeror's representation of exemption should suffice it could have said so, but it did not," adding that it was unnecessary to look to the legislative history of NSMIA since "[*t*]*he statute is unambiguous.*"[245] In making their assessments of Rule 506 compliance, the states actually would be complementing Congress's exemptive scheme by monitoring and ensuring compliance. These efforts would actually achieve the regulatory uniformity that drove Congress to enact NSMIA in the first place.[246] In other words, issuers only have to comply with one set of directions rather than inconsistent directions from the various states.[247] State review of an issuer's compliance with federal law is not an additional level of regulation.

Indeed, Section 18(b)(4)(E),[248] in designating Rule 506 offerings as covered securities, invites the states to impose substantially the same notice requirements as the Form Ds required to be filed with the SEC under Regulation D. This authorization is reiterated in Section 18(c)(2), which provides that state securities regulatory authorities may require the filing of any document filed with the SEC, together with annual or periodic reports of the value of securities offered or sold to persons located in their respective jurisdictions, for notice purposes, assessment of filing fees, and securing the issuer's consent to service of process.[249] This provision is followed by Section 18(c)(3) which specifically preserves the power of the states to suspend any offer or sale of securities whenever this required filing (and payment of attendant fees) is

241 *Id.* at 296.

242 *Id.*

243 Brown v. Earthboard Sports USA, Inc. 481 F.3d 901 (6th Cir. 2007).

244 *Id.* at 911 (emphasis added) (quoting Grubka v. WebAccess Int'l, 445 F. Supp. 2d 1259, 1269–71 (D. Colo. 2006)).

245 *Id.*

246 One of the most important objectives Congress sought to achieve by its enactment of NSMIA was "to make securities laws more uniform with the historic mission of state blue sky laws to protect investors." Robert N. Rapp & Fritz E. Berckmueller, *Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 63 BUS. LAW. 809, 815 (2008).

247 The states' enforcement of the SEC's Rule 506 exemptive scheme resolves the inconsistencies and avoids the "societal nervous breakdown" that American federalism has been said to portend. *See generally* Henry M. Hart, Jr., *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489 (1954) (discussing these alleged consequences that result from having two conflicting sets of laws at the State and federal levels).

248 Securities Act of 1933 § 18(b)(4)(E), 15 U.S.C. § 77r(b)(4)(E) (2012).

249 *Id.* § 18(c)(2), 15 U.S.C. § 77r(c)(2)(A).

not made.[250] In addition, Section 18(c)(1) specifically preserves the powers of the states to "investigate and bring enforcement actions in connection with securities or securities transactions with respect to fraud or deceit,"[251] and, presumably, to enforce their own registration and exemptive schemes where nominally Rule 506 covered securities have been uncovered or disrobed as a result of their investigations. Clearly nothing in the 1933 Act prohibits the states from thoroughly scrutinizing the Form Ds that are filed with them to assess compliance with Rule 506, to determine whether their registration and exemptive schemes are applicable or preempted, and to ascertain whether the offering would work a fraud on investors. Moreover, in addition to granting state courts concurrent jurisdiction of all suits in equity and actions at law to enforce all liabilities and duties created by the statute,[252] the 1933 Act specifically states that despite its general limitations on class actions involving covered securities, the states are not precluded from bringing their own actions involving covered securities.[253] Vigorous scrutiny by the states helps fill the regulatory gap by ensuring that the SEC's Rule 506 exemptive scheme does not fall prey to abusive issuers, thereby diminishing investor confidence in the private offering marketplace.

The states have multiple investigatory powers and enforcement methodologies available to them in ferreting out securities offerings that have not been registered but should have been and offerings that are fraught with fraudulent misrepresentations and omissions. In coordination with Sections 18(c)(2) and (c)(3) of the 1933 Act, the Uniform Securities Act of 1956,[254] enacted in whole or in part by some two–thirds of the states,[255] specifically authorizes state administrators to require that Rule 506 issuers file the SEC's Form D and a consent to service of process with their offices, and permits state administrators to issue stop orders suspending the offer and sale of securities for those issuers' failure to comply.[256] In addition, the Uniform Securities Act makes it unlawful to file any document, including a Form D, that is false or misleading in any material respect.[257] Certainly, issuers who falsely claim a Rule 506 exemption or otherwise make material misrepresentations in their Form Ds filed with the states are engaged in conduct that is unlawful under this provision. The states are authorized under the Uniform Securities Act to

250 *Id.* § 18(c)(3), 15 U.S.C. § 77r(c)(3).

251 *Id.* § 18(c)(1)(a)(i), 15 U.S.C. § 77r(c)(1)(A)(i).

252 *Id.* § 22(a), 15 U.S.C. § 77v(a).

253 *Id.* § 16(d)(2)(A), 15 U.S.C. § 77p(d)(2)(A).

254 UNIF. SEC. ACT (amended 1958), 7C U.L.A. 745 app.I (2006).

255 *See* UNIF. SEC. ACT (2002), prefatory note, 7C U.L.A. 2 (2006) ("The Uniform Securities Act of 1956 ('1956 Act') has been adopted at one time or another, in whole or in part, by 37 jurisdictions.").

256 UNIF. SEC. ACT (amended 1958) § 302(b), 7C U.L.A. 803 app.I (2006); *see also* UNIF. SEC. ACT (2002), § 302(c), 7C U.L.A 75 (2006).

257 *Id.* § 404, 7C U.L.A. 865 app.I.

issue cease and desist orders, to bring injunctive actions, and to seek criminal penalties, including fines and imprisonment, for violations of this and other provisions of their statutes, rules, and orders.[258]

State review of Form Ds, despite their limited content, is certainly a useful starting point for assessing both the applicability of the Rule 506 preemption exemption and the probabilities of registration and antifraud violations. The present content requirements are essentially those identified previously in my discussion of the proposed Advance Form D,[259] content that would be significantly augmented by additional content requirements for the required subsequent filing fifteen days after the first sale, as provided in the SEC's proposed amendments.[260] The Form D, as it stands, is roughly four pages long and poses sixteen questions, and the SEC's rules do not presently require that Form Ds be accompanied by disclosure documents, or, in the case of Rule 506(c) offerings, any written general solicitation materials used by issuers.[261] Nevertheless, the Form D does serve to apprise state regulatory authorities that securities offerings are being conducted in their respective jurisdictions. It also provides, through an issuer's responses to those sixteen questions, a *rudimentary* basis for analysis. The SEC's Office of Inspector General has recognized that the information about private offerings required in Form D assists both state regulators and FINRA in the enforcement of both securities laws and financial industry rules, respectively.[262] Indeed, the SEC, in its recently proposed amendments to Regulation D and Form D, reiterated its belief that its "proposed changes to the filing and information requirements of Form D could assist the enforcement efforts of both federal and state regulators, which rely on Form D as an important source of information about the private offering market."[263] It also affirmed that, historically, Form D has served as a source of information for investors and facilitated the enforcement efforts of state securities regulators.[264] The SEC specifically acknowledged comments that "state securities regulators routinely review Form D filings to ensure that the offerings actually qualify for an exemption under Rule 506 and to look for 'red flags' that may indicate that an offering may be fraudulent."[265] As one prominent state regulator recently observed, "[t]he states have a particular

258 *See id.* §§ 408–409, 7C U.L.A. 870–73 app.I.

259 *See supra* notes 148–50 and accompanying text.

260 *See supra* notes 148–56 and accompanying text.

261 *See* Form D, 17 C.F.R. § 239.500 (2013); *see also* SEC. EXCH. COMM'N, FORM D: NOTICE OF EXEMPT OFFERING OF SECURITIES, *available at* https://www.sec.gov/about/forms/formd.pdf (last visited Mar. 22, 2014).

262 OIG REPORT, *supra* note 206, at 5.

263 Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806, 44,808 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 & 239).

264 *Id.* at 44,810.

265 *Id.* at 44,811.

interest in Form D filings because they serve as a window into an otherwise opaque or invisible market for securities."[266]

To the extent state regulators feel constrained in their review of Form Ds because of the status of Rule 506 offerings as covered securities, they should not be. The purposes of Form D include not only the collection of statistical data but also the enforcement of both state and federal securities laws.[267] In the new world of publicly offered private offerings of covered securities, the states must unite in their efforts to disrobe securities that do not deserve to be covered. Issuers that claim their offerings are covered when they patently are not deserve to be prosecuted for violations of both registration and antifraud provisions of state securities laws. NASAA could constructively enhance the enforcement efforts of the states by adopting a *policy statement* urging all the states to engage in the systematic review of Form D filings under Rules 506(b) and 506(c). It should also develop, in consultation with its member states, uniform Form D review guidelines. These guidelines would serve to streamline the review process to better ensure consistency and efficiency among state regulatory authorities in screening Form Ds to detect failures to comply with the strictures of Rules 506(b), 506(c), and 506(d), to enforce violations of state registration and exemptive scheme requirements, and to detect and enforce state antifraud rules. Any review guidelines should be structured to identify and flag for further inquiry of only those offerings most likely to be problematic and not to nitpick reputable issuers, promoters, and securities counsel. The underlying policy should be the protection of retail investors through early stage detection of those offerings most likely to be abusive. Admittedly limited by my lack of state regulatory and enforcement experience, I have developed a rudimentary first draft, set forth below, for consideration by NASAA and state securities regulatory authorities.

> Uniform Form D Review Guidelines
>
> (1) Review the issuer's state of formation and verify whether it has, in fact, been formed as represented, and whether it is in good standing under the law of the state of formation. If not, the offering should be flagged for further review. (Form D, Item 1).
>
> (2) Review the issuer's date of formation, and, if not yet formed, the offering should be flagged for further review,

266 Letter from William Francis Galvin, Sec'y, Commonwealth of Mass., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 3 (Sept. 23, 2013), *available at* http://www.sec.gov/comments/s7-06-13/s70613-394.pdf.

267 Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. at 44,810.

since securities are being offered by a nonexistent issuer. (Form D, Item 1).

(3) Review the issuer's type of business, and, if engaged in a business commonly associated with fraudulent conduct, the offering should be flagged for further review. (Form D, Item 1 and Item 4).

(4) Conduct a bad actor review for the issuer and related persons, including the issuer's officers, directors, partners, managing members and promoters. If bad actors are identified, the offering, pursuant to Rule 506(d), would not be exempt under Rule 506(b) or (c), and the state may no longer be preempted from enforcing its own regulatory requirements. Moreover, if the issuer is disqualified from reliance on Rule 506, consider whether the issuer may have misrepresented to offerees that its offering is exempt from state and federal registration, which would be materially misleading. Note, Form D now requires issuer *certification* that no bad actors are associated with offerings under Rule 506. The issuer also may not have disclosed these adverse regulatory histories to offerees, which would constitute a material misrepresentation or omission. (Form D, Item 1 and Item 3).

(5) Conduct both registration and bad actor reviews of all recipients of sales compensation. If those engaged in selling the securities are not registered as broker–dealers or are not clearly exempt, the offering should be flagged for further review. Note that many abusive offerings often involve unregistered investment finders. In addition, if bad actors are identified, the issuer would not be eligible to rely on Rule 506(b) or (c), and the state may no longer be preempted from enforcing its own regulatory requirements. In addition, consider whether the issuer may have misrepresented to offerees that its offering is exempt from state and federal registration, which would be materially misleading. Again, Form D requires issuer certification that no bad actors are associated with offerings under Rule 506. If the issuer has not disclosed adverse regulatory histories to offerees, it is likely to have made material misrepresentations or omissions to investors. (Form D, Items 12 and 15).

(6) Review the number of non–accredited investors in the offering, and, if any, the offering should be flagged for

further review since experienced securities lawyers routinely discourage private offerings to non–accredited investors, and, consequently, there may be no lawyer acting as a gatekeeper, thereby increasing investor risks. If the number of non–accredited investors exceeds 35, the offering may not qualify for the Rule 506(b) exemption. If there are any non–accredited investors, the offering does not qualify for the Rule 506(c) exemption. If the exemption is unavailable, the state is no longer preempted from enforcement of its own registration and exemptive requirements. Moreover, the issuer has likely misrepresented to offerees that its offering is exempt from state and federal registration, which would be materially misleading. (Form D, Item 14).

(7) Review the required minimum investment in the offering, and, if less than $10,000, the offering should be flagged for further review since reputable securities lawyers rarely assist issuers in private offerings requiring no or relatively small minimum investments. (Form D, Item 11).

(8) Review use of proceeds to determine whether substantial portions of the offering proceeds are being distributed to insiders, and, if so, the offering should be flagged for further review. (Form D, Item 16).

(9) Review whether the issuer is a pooled investment fund, and, if so, determine whether the investment adviser to the fund is appropriately registered with the state or the SEC as an investment adviser and conduct a bad actor review of that investment advisor. (Form D, Item 9).

(10) In Rule 506(c) offerings, consider whether to contact the issuer or its counsel to determine what reasonable steps are being taken to verify the accredited investor status of purchasers. If the issuer accepts self–certification or otherwise fails to engage in reasonable verification procedures, the issuer would not be eligible to use Rule 506(c), and the state may no longer be preempted from enforcing its own regulatory regime. (Form D, Item 6).

(11) Review issuer size based on revenues and assets, and, if the issuer has no revenues or no assets, or has "declined to disclose," the offering should be flagged for further review. (Form D, Item 5).

> (12) Review whether the issuer and its principals have strong connections to their communities and whether the offering involves reputable lawyers or financial intermediaries subject to FINRA and state regulation. If not, the offering should be flagged for further review. On the other hand, offerings involving *bona fide* gatekeepers typically are less inclined to be fraudulent. (Form D, Item 1, Item 2, Item 12 and Signature).
>
> (13) Review Form D for its completeness, and, if answers are either incorrect, nonresponsive, or not provided, the offering should be flagged for further review. Note Rule 503(a), which states that an issuer must file an amendment to Form D to correct material mistakes of facts or errors as soon as practicable after discovery (unless the change reflects only certain information prescribed in the rule), and the issuer must file a Form D annually if the offering is continuing beyond one year. (Form D).
>
> (14) Locate and review the issuer's website, if any, to determine whether inconsistencies appear when compared to the Form D. (Form D).[268]

These draft guidelines provide only one example of how Form Ds' sixteen questions, as they presently stand without the SEC's proposed content enhancements, might be more thoughtfully reviewed. Without doubt, experienced state regulators, coordinated by NASAA, could develop a more in–depth and effective model. NASAA's development of Form D review guidelines should prove significantly beneficial to both novice and experienced regulators in conducting their Form D reviews. Once in place, NASAA's uniform review guidelines should be "generally advertised," as part of an "issuer education" program. Many dishonest issuers and their counsel, if any, would soon realize that the states are both empowered and engaged in the marketplace for private placements of both covered and disrobed securities.

B. Implementation of the Electronic Form D Depository

Over a decade ago, I proposed that the states develop a web–based *central notification depository*, coordinated by NASAA, that would be functionally equivalent to the Central Registration Depository for market professionals,

268 The markers I have identified in these review guidelines should not be viewed as necessarily problematic and, indeed, may be present for legitimate reasons. They are provided solely to suggest that further review of a given offering might be warranted. *See generally* U.S. SEC. & EXCH. COMM'N, FORM D, *supra* note 261.

which has been successfully established by NASAA and the National Association of Securities Dealers (NASD, now succeeded by FINRA).[269] In NSMIA, Congress authorized the states, among other things, to require issuers filing Form Ds with the SEC in connection with their private offerings of securities to also file those Form Ds with state regulatory authorities, together with attendant fees and consents to service of process.[270] Congress expressly authorized state regulators to suspend any offering of securities made within their respective states if issuers failed to file these forms.[271] As discussed above, the Form D provides significant investigatory opportunities.[272]

The SEC, working with NASAA, modified Form D in 1986 to make it a uniform notification form that could be filed both with the SEC and state securities regulators.[273] It has repeatedly recognized not only that Form D is used by state securities regulators and FINRA to enforce securities laws, but also serves as an important source of information for investors, information vendors, venture capitalists, and an issuer's competitors.[274] In 2008, to ensure

269 Warren, *Reallocation*, *supra* note 35, at 510–11. The Central Registration Depository (CRD) facilitates simultaneous registration of broker–dealers and their agents with FINRA and the states. *See Central Registration Depository*, FINRA, http://www.finra.org/industry/compliance/registration/crd/ (last visited Mar. 10, 2014).

270 Securities Act of 1933 § 18(c)(2), 15 U.S.C. § 77r(c)(2)(A) (2012).

271 *Id.* § 18(c)(3), § 77r(c)(3).

272 *See supra* Part III.A.

273 Form D and Regulation D, Securities Act Release No. 6663, 51 Fed. Reg. 36,385 (Oct. 10, 1986) (to be codified at 17 C.F.R. pts. 230 & 239). The SEC, at the time it imposed electronic filing for Form Ds, stated, "[w]e modified the requirements relating to Form D in 1986, making Form D a uniform notification form that could be filed with state securities regulators." Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. 10,592, 10,592–93 (Feb. 27, 2008) (to be codified at 17 C.F.R. pts. 230, 232 & 239).

274 The SEC has repeatedly affirmed the broad purposes of Form D filings:

> The staffs of state securities regulators and the Financial Industry Regulatory Authority (FINRA), the successor to the member firm regulatory functions of the National Association of Securities Dealers, Inc. and NYSE Regulation, Inc., also use Form D information to enforce securities laws and the rules of securities self–regulatory organizations. Form D filings also have become a source of information for investors. Our Web site advises potential investors in Regulation D offerings to check whether the company making the offering has filed a Form D notice and advises that "[i]f the company has not filed a Form D, this should alert you that the company might not be in compliance with the federal securities laws." In addition, the information in Form D filings serves as a source of business intelligence for commercial information vendors, as well as for participants in the venture capital, private equity, and other industries that rely on Regulation D offerings and for competitors of companies that file Form D information. Academic researchers use Form D information to conduct empirical research aimed at improving the workings of these industries. Journalists use Form D information to report on capital–raising in these industries.

Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. at 10,593 (footnotes omitted).

Indeed, in its recent proposals for further amendment of Form D to expand its disclosure requirements, the SEC stated, "we believe that the proposed changes to the filing and information requirements of Form D could assist the enforcement efforts of both federal and state regulators, which rely on Form D as an important source of information about the private offering market."

that Form D would be more readily available to both regulators and the public, the SEC issued new Form D rules requiring that Form Ds be filed electronically through an online filing system that would automatically capture and tag data items and make that data interactive and searchable.[275] In its adopting release, the SEC embraced the concept of "one stop filing" to promote greater uniformity and coordination between federal and state securities regulation.[276] As envisioned by the SEC, "[o]ne stop filing [would] enable companies to file Form D information both with us and with the states they designate in one electronic transaction."[277] It announced that it was already working with NASAA to develop an interface between the SEC's electronic system and an electronic system to be developed by NASAA that would receive the SEC's filings and collect fees on behalf of participating states securities regulators.[278] Although the SEC stated that it "[has] been working actively with NASAA to achieve that capability as soon as practicable,"[279] this collaboration proved to be painstakingly slow. Due to a communications breakdown with the SEC, NASAA was already frustrated that the state filing system was not launched *in tandem* with the SEC's electronic filing system.[280] Instead, issuers could file their Form Ds electronically with the SEC's Electronic Data Gathering and Retrieval System (EDGAR) but had to continue filing paper copies with their respective state regulators.[281] In 2009, the Office of Inspector General (OIG) soundly criticized the SEC's failure to effectively coordinate with NASAA in the development of an EDGAR link to the NASAA sponsored system.[282]

Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806, 44,808 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 & 239).

275 Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. 10,592.

276 *Id.* at 10,594–95.

277 *Id.* at 10,594, 10,612.

278 *Id.* at 10,594. The SEC, in its release adopting Form D electronic filing requirements, stated:

> The system will enhance uniformity and coordination even more if it results in "one-stop filing," an approach we and NASAA are exploring. One-stop filing will enable companies to file Form D information both with us and with the states they designate in one electronic transaction. While that capability will not be available when Form D electronic filing with the Commission begins, we have been working actively with NASAA to achieve that capability as soon as practicable. We understand that NASAA is considering establishing its own new electronic system that would interface with our system and would receive filings and collect fees on behalf of participating state securities regulators. One-stop filing will reduce significantly the costs and burdens of preparing and filing Form D information with the Commission and with state securities regulators. This could represent a substantial savings for small businesses and others filing Form D information.

Id. (footnote omitted).

279 *Id.*

280 *See* OIG REPORT, *supra* note 206, at 31.

281 *Id.* at vi.

282 *Id.* at 29–32.

In an effort to remedy this failure, the OIG issued Recommendation 16, stating: "The [SEC's] Division of Corporation Finance should timely and appropriately coordinate with staff at [NASAA] to develop a system that can be linked to the Commission's [EDGAR], enabling issuers to file Form D electronically with the states."[283] The SEC, in its response, stated simply, "We will continue to work with NASAA on this."[284]

Since the OIG's recommendation in 2009, progress has advanced at a glacial pace. Approximately a year later, on April 5, 2010, the SEC and NASAA entered into a Memorandum of Understanding,[285] in which the SEC agreed, upon prior notice from NASAA, to include in SEC e-mails to issuers confirming their successful Form D filings the following message: "STATE FILINGS: If you also wish to file the information in your filing online with one or more U.S. states or territories, please visit http://efd.nasaa.org."[286] The SEC further agreed to coordinate its own EDGAR-based system with NASAA's developmental stage electronic Form D depository, EFD, an acronym for Electronic Filing of Form D.[287]

During the period following execution of the Memorandum of Understanding, NASAA worked with a third party consultant to develop its EFD system, but, nearing completion, that vendor unilaterally terminated the contract.[288] At the present time, NASAA, working through its Regulation D Electronic Filing Committee, has negotiated a contract with another consultant, which includes some 125 pages of detailed system requirements that will be incorporated into the final contract.[289] The NASAA committee now anticipates that its EFD system will be fully operational within the next twelve months.[290]

283 *Id.* at 33, app. VI at 48.

284 *Id.* app. VII at 57.

285 Memorandum of Understanding Between the U.S. SEC and N. Am. Sec. Adm'rs Ass'n, Inc. (Apr. 5, 2010), *available at* http://www.sec.gov/info/smallbus/nasaa-mou-040510.pdf.

286 *Id.* at 2.

287 *See id.* at 2–3.

288 *See* Alan Parness, *The Curmudgeon's Corner – Some Further Thoughts on Rule 506 Offerings*, MONDAQ (Sept. 12, 2012), www.mondaq.com/unitedstates/x/196328/Commodities+Derivatives+Stock+Exchanges/The+Curmudgeons+Corner+Some+Further+Thoughts+On+Rule+506+Offerings.

289 *See* Telephone Interview with Faith Anderson, Chief of Registration & Gen. Counsel, Wash. Dep't of Fin. Insts., Sec. Div. (Sept. 24, 2013).

290 Telephone Interview with Rick Fleming, Deputy Gen. Counsel, NASAA (Sept. 18, 2013).

The new system, designed to be much more user friendly than EDGAR, will establish the following process:

> (1) The issuer or its counsel files Form D electronically with the SEC's EDGAR system.
>
> (2) EDGAR generates an e-mail confirmation of receipt of the Form D filing, providing an EFD link for the issuer to make state Form D filings and payment of state filing fees.
>
> (3) After the issuer clicks on the link, EFD will grab the EDGAR data from the issuer's Form D and ask the issuer to identify the state where the first sale has occurred and additional states in which the issuer would like to file.
>
> (4) The issuer will then check off those states online.
>
> (5) EFD will then present an invoice for related filing fees.
>
> (6) The issuer will then provide credit card information for electronic payment of fees, which EFD will then remit to state securities authorities.[291]

While issuers may also file their Form Ds directly with the EFD without going through the EDGAR link, they are likely to benefit in terms of time, cost, and efficiency by use of the EDGAR-EFD one stop filing system.[292] Once in place, the EFD filing system should be accessible not only to issuers and their counsel but also to investors and the general public as a valuable source of information on private offerings in their respective communities.[293]

The prompt implementation of the EFD system will represent an important advance in federal-state coordination of securities regulation in the private offering marketplace. As the SEC concluded some five years ago, "[o]ne-stop filing will reduce significantly the costs and burdens of preparing and filing Form D information with the Commission and with state securities regulators."[294] Moreover, it is likely to result in substantial savings for small businesses engaged in exempt private offerings of their securities. NASAA's EFD system, hoped to be in full operation next year, will constructively complement the collective

291 *See* Interview with Faith Anderson, *supra* note 289.

292 Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57,280, Investment Company Act Release No. 28,145, 73 Fed. Reg. 10,592, 10,593-94 (Feb. 27, 2008) (to be codified at 17 C.F.R. pts. 230, 232 & 239).

293 *See id.* at 10,594, 10,595, 10,597.

294 *Id.* at 10,594.

efforts of the states to monitor and enforce the SEC's exemptive scheme for both Rule 506(b) and Rule 506(c) private offerings.[295]

C. Development of the Bad Actor Database

The SEC's recent adoption of Rule 506 bad actor rules, as mandated by the Dodd–Frank Act, has imposed vitally important obligations on virtually all issuers of private offerings under Regulation D.[296] For the first time in the thirty–year history of Regulation D, issuers will be disqualified from reliance on the Rule 506 exemption from registration if they or their associated principals and promoters have been subject to a broad array of disqualifying events.[297] While I have recognized in this Article that this regulatory development is "good news" for state regulators, it also imposes new responsibilities on those regulators to ensure compliance. In fulfilling those responsibilities, state regulators—and the local marketplaces they protect—would greatly benefit from the creation of a publicly accessible bad actor database (BAD) that would permit issuers, securities lawyers, promoters, financial intermediaries, and, most importantly, investors, to identify those bad actors before bad deals are consummated and investors' savings are lost.

The SEC's bad actor rule, Rule 506(d), sets forth a laundry list of "covered persons"[298] subject to another laundry list of "disqualifying events,"[299] as summarized respectively, below:

> Covered Persons
> - The issuer and any predecessor of the issuer or affiliated issuer;
> - Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
> - Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
> - Any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager, as well as any director, executive officer or officer participating in the

295 *See id.* at 10,593 & n.30, 10,612.

296 *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730, 44,737 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239).

297 *Id.* at 44,731–32.

298 *Id.* at 44,737 (citing Rule 506(d)(1), 17 C.F.R. § 230.506(d)(1) (2013)).

299 *Id.* at 44,737–38.

offering of any such general partner or managing member;
- Any promoter connected with the issuer in any capacity at the time of the sale;
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering (which we refer to as a "compensated solicitor"); and
- Any director, executive officer, other officer participating in the offering, general partner, or managing member of any such compensated solicitor.

....

Disqualifying Events
- Criminal convictions (felony or misdemeanor), entered within the last five years in the case of issuers and ten years in the case of other covered persons, in connection with the purchase or sale of any security; involving the making of a false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Court injunctions and restraining orders, including any order, judgment or decree ... entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security; involving the making of any false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Final orders issued by state banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either create a bar from association with any entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking or from savings association or credit union activities; or are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years;
- Commission disciplinary orders ... that, at time of the sale, suspend or revoke a person's registration as a broker, dealer, municipal securities dealer or investment adviser; place limitations on the activities, functions or operations of such

> person; or bar such person from being associated with any entity or from participating in the offering of any penny stock;
> - Suspension or expulsion from membership in, or suspension or a bar from association with a member of, an SRO, *i.e.*, a registered national securities exchange or a registered national or affiliated securities association;
> - Stop orders . . . and orders suspending the Regulation A exemption . . . filed . . . within the last five years [before such sale]; and
> - U.S. Postal Service false representation orders . . . entered within five years.[300]

These respective criteria involve relatively unique data points that provide particular challenges for issuers and their counsel and, perhaps, even for regulators in their search for bad actors in unregistered private offerings. All but the most sophisticated investors would be befuddled and certainly frustrated in any online searches they undertake to protect themselves.

The SEC accords issuers limited protection by the inclusion of a reasonable care exception.[301] In circumstances where an issuer that has commenced or completed a private offering under Rule 506 realizes the offering is tainted by the involvement of bad actors, the offering will not be disqualified if the issuer can show that it did not, and in the exercise of "reasonable care," could not have known of the disqualification.[302] The issuer seeking to save its Rule 506 exemption would have the burden of proof in establishing its own reasonable care and, accordingly, the applicability of the exception.[303] The SEC has further limited the reasonable care exception through its adoption of a regulatory instruction:

> An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, *factual inquiry* into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.[304]

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300 *Id.* (footnotes omitted). For an excellent synopsis of both the dual Rule 506 exemptions and the bad actor rules applicable to those exemptions, see Paul Weiss, Client Memorandum, *How Will the SEC's New Reg D Rules Affect Offerings by Private Funds?* (Jul. 17, 2013), *available at* www.paulweiss.com/media/1717486/17july13_sec.pdf.

301 *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,745–47. The SEC based its reasonable care exception on the NASAA–approved Model Accredited Investor Exemption, which requires issuers to perform factual inquiries before asserting the reasonable care exception. *Id.* at 44,746.

302 *See id.* at 44,745.

303 *See id.* at 44,771.

304 *Id.* (emphasis added).

The SEC, in its Rule 506(d) adopting release, expressly declined "to prescribe specific steps as ... necessary or sufficient to establish reasonable care."[305] While suggesting that, at least where no red flags are evident, the required factual inquiry might be accomplished through questionnaires and certifications, perhaps accompanied by covenants and contractual representations, the SEC has not provided any definitive guidance.[306] This *reasonable care based on factual inquiry* standard also applies to the SEC's newly imposed obligation that the issuer must make written disclosures of any disqualifying events that occurred before the effective date of the rule to all investors, prior to their purchase of the issuer's securities.[307] Regardless of whether they are ultimately positioned to assert reasonable care defenses, issuers are now required by Form D to *certify* to the SEC and state regulators and, in effect, to represent to investors, that they are not disqualified.[308] Of course investors are not protected by the issuer's reasonable care defense and may indeed suffer grievous losses when issuers who were disqualified proclaim after the fact, "oops, but I made reasonable factual inquiries." This "oops" excuse would not appear viable if the issuer did not rationally undertake the factual inquiry in a way that would actually cover the numerous data points prescribed by the rule.

Most small businesses, particularly start–ups, are likely to find it extremely difficult to undertake the due diligence required to ferret out the "covered persons" under the rule, much less the various "disqualifying events" identified. For those few who turn to experienced securities counsel, they will find that no standardized procedures or "best practices" have been established. Most lawyers routinely Google their new clients for risk management and due diligence reasons and, in connection with securities offerings, generally require officers,

305 *Id.* at 44,746.

306 *See supra* note 136 and accompanying text. With regard to the timing of the bad actor determination, the SEC has recently interpreted Rule 506(d) as requiring issuers to make those determinations "any time they are offering or selling securities in reliance on Rule 506." *Securities Act Rules: Compliance and Disclosure Interpretations (C&DI's), Question 260.14*, U.S. SEC. & EXCHANGE COMMISSION (Dec. 4, 2013), http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm. The SEC stated:

> An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, if an offering is continuous, delayed or long–lived, the issuer must update its factual inquiry periodically through bring–down of representations, questionnaires and certifications, negative consent letters, periodic re–checking of public databases, and other steps, depending on the circumstances.

Id.

307 *See supra* note 136 and accompanying text; *see also* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,745–47 (discussing the reasonable care exception).

308 *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. at 44,771. The SEC amended Form D to require certification by any issuer claiming a Regulation D exemption that "the issuer is not disqualified from relying on Regulation D for one of the reasons stated in Rule 505(b)(2)(iii) or Rule 506(d)." *Id.*

directors, and controlling persons to complete insider questionnaires—and now, perhaps, disqualification questionnaires—to identify any adverse regulatory histories.[309] With respect to new clients undertaking private placements, an issuer's securities lawyer might obtain client releases and choose among a varied menu of background checks available from third party vendors.[310] In performing their customary due diligence on an issuer's securities offering, lawyers typically perform background checks that include proper formation and good standing, verification of necessary professional and business licenses and registrations, UCC checks, credit reports, and CRD information accessed through Broker Check.[311] However, good faith efforts to mine these typically used databases, while generally necessary to satisfy due diligence standards, are not likely to reveal complete securities enforcement regulatory histories of those involved in a particular securities offering.[312] Such databases simply do not cover the data points set forth in Rule 506(d), no matter how intense the good faith of the effort. In other words, the background searches undertaken are not rationally tied to those precise data points and to my knowledge no database has been created, and none has been mandated by the SEC, that would present the required information. This, of course, begs the question whether a reasonable care defense should—or can—protect issuers when their factual inquiries, including multiple background checks undertaken at considerable expense, are simply not designed to reach all of the covered persons and disqualifying events prescribed by the rule.

Based on my own prior experience as a securities lawyer and my continual discussions with active practitioners, securities lawyers do not follow any standard processes to determine bad actor participation in private securities offerings and, in fact, cannot easily access the types of information required by the rule. For example, state civil and administrative orders, including those against unregistered sales agents, are supposed to be filed with the CRD by state regulators on Form U-6's but often are not.[313] Even if lawyers pursue the arduous and time-consuming challenge of taking covered persons through links on NASAA's website and the websites of the fifty state regulators, the results are unlikely to be complete. Moreover, civil and administrative actions have not been merged with criminal actions into a single database.[314] Securities regulators themselves have substantial difficulties in scraping off bad actor data from multiple databases.[315] Issuers and their lawyers, even in those private offerings where issuers retain them, may simply decide to do the best

309 *See* Interview with Rick Fleming, *supra* note 290.

310 Interview with Carolyn Duncan, *supra* note 213.

311 *See id.*

312 *See supra* note 136 and accompanying text.

313 *See* Interview with Carolyn Duncan, *supra* note 213.

314 *Id.*

315 *See generally id.* (discussing the various sources from which to obtain bad actor information).

they can under the circumstances, knowing that they cannot state with any real confidence that their clients' offerings are clean. If a BAD system were in place, it would enable bona fide issuers and their lawyers to make rational factual inquiries by accessing a centralized database that actually provides, at least to the extent practicable, the best information available on the prescribed covered persons and disqualifying events. Indeed, best practice standards would immediately include a required search of the BAD system. In developing the system, NASAA could defray its expense by charging reasonable access fees to issuers and their counsel, who in turn would have an electronic trail to evidence their factual inquiries. Most importantly, use of the BAD system would serve to filter private offerings and thus achieve early stage protection of retail and other investors. The BAD system would vastly enhance the protection of investors in private offerings, who presently are even more challenged than bona fide issuers by the daunting task of determining whether the promoters offering unregistered securities are frequent flyers.

The standard advice now offered investors by NASAA and state regulators is to visit their websites, read the investor alerts, click the links to Broker Check, and telephone their offices.[316] As previously discussed, however, this process, though obviously providing significant protection, remains amorphous. State enforcement data has not yet been centralized in a single NASAA database, much less the civil and criminal histories of the entities and individuals covered by the bad actor rule. NASAA's creation of a database tailored to those persons covered by the bad actor rule and to the disqualifying events prescribed would solve the conundrum now faced by both issuers and investors. With the BAD system in place, investors would be able to ascertain with more certainty whether bad actors are participants in a given offering. Granted, the BAD system would hardly be perfect. Perpetrators of securities law violations are not tagged with social security numbers or other identifiers in most criminal, civil, and administrative proceedings. They often have common names, often change their names, and often use relatives and other cohorts as fronts in their operations. While no database can ever be free of flaws, the BAD system would offer a great deal more protection than presently available. It would arm issuers, investors, and securities regulators themselves with an invaluable tool in the fight against securities fraud. Certainly, it would significantly complement the impressive results achieved by NASAA and state regulators in recent years through the development of extensive investor education programs designed to improve the financial literacy of retail investors in their respective communities.[317] According to FINRA's recent fraud susceptibility study, most retail investors are unable to

316 *How to Check Out Your Broker or Investment Adviser*, NASAA, http://www.nasaa.org/2709/how-to-check-out-your-broker-or-investment-adviser/ (last visited Mar. 22, 2014).

317 *See* Subcomm. on Fin. Insts. & Consumer Credit of the Comm. on Fin. Servs., *Improving Financial Literacy: Working Together to Develop Private Sector Coordination and Solutions*, NASAA (Sept. 28, 2006), http://www.nasaa.org/858/nasaa-written-statement-on-investor-education-submitted-to-house-committee-on-financial-services-subcommittee/.

identify the classic red flags of fraud and approximately 40% of investors found "fully guaranteed" investments and investments offering 110% annual returns appealing financial opportunities, despite the fact that these investments are "too good to be true."[318] NASAA and the state regulators obviously should be encouraged to continue development of their investor education programs, including online courses, seminars, and curriculum enhancement in our schools, in order to reduce investor susceptibility to securities fraud. These programs are admirably geared toward teaching investors how to invest. The BAD system would provide these investors with a creditable list of who not to trust.

CONCLUSION

Congress, in Title II of the JOBS Act, concluded that what the country needed was a fundamental change in the regulatory structure of its primary capital market. What we needed, in order to help small businesses secure investment capital and then create jobs for our citizens, was two clear-cut regulatory options. If a company wants to raise equity or debt capital from the general public, it should be positioned to choose between a "bright offering" of securities or a "dark offering" of securities. A bright offering of securities, available through the federal registration process, would entail administrative review of a biblically extensive core disclosure document, accompanied by audited financial statements, imposing strict liability for material misrepresentations and omissions, and triggering publicly available periodic reporting requirements. Alternatively, a dark offering of securities, available through the federal exemptive process, would entail no registration at the state or federal level, no formal preparation and delivery of a disclosure document, no administrative review, no audited financial statements, no strict liability for material misrepresentations and omissions, and no periodic reporting requirements. In other words, issuers should be able to choose between a fully sunlit offering and sunlit operations thereafter or a dark offering followed by an operational life in the shadows.

Of course, since the advent of our dual regulatory system in the United States, the light versus dark options have always been there. What has recently changed is the manner in which those offerings might be conducted. If you wanted to offer to the general public, an issuer had to pursue the bright offering. If the issuer wanted to stay dark, it had to offer its securities privately, either to insiders or to outsiders who had physical and intellectual access to the company's core information. While the bright option has remained generally the same over the past eighty years, the dark option gradually was liberalized, at first to the point where issuers could offer securities privately to investors

318 *See* APPLIED RESEARCH & CONSULTING LLC, FINANCIAL FRAUD AND FRAUD SUSCEPTIBILITY IN THE UNITED STATES: RESEARCH REPORT – PREPARED FOR THE FINRA INVESTOR EDUCATION FOUNDATION 3 (2013), *available at* http://www.finra.org/web/groups/sai/@sai/documents/sai_original_content/p337731.pdf.

who did not have access to the company's core information, but with whom the issuer had some substantive pre–existing relationship and who earned $200,000 a year or were worth $1,000,000.[319] The only major restraint was that those issuers launching dark offerings were prohibited from offering their securities to the general public. They could not offer and sell securities on Sirius XM Radio, television commercials or other broadcast media, through newspaper and magazine ads, or through solicitations on the sides of buses and on highway billboards, through cold calls to strangers listed in phone books or the Internet. In other words, dark offerings had to be cast to a narrow range of potential investors.

In enacting the JOBS Act, Congress decided, as a matter of public policy aimed at promoting capital formation and creating jobs, to eliminate the ban on general solicitation in the conduct of private placements.[320] In its view, issuers should be able to solicit investments from everyone, through widespread public advertising, so long as, in the end, only those earning $200,000 a year or worth a million dollars actually bought the advertised securities. Congress has assumed that these presumptively rich investors surely can fend for themselves and do not need the protection afforded by a formal disclosure document, do not need access to core information about the issuer and its securities, and do not need any presale review by state or federal regulators. In other words—'just go advertise everywhere and sell to these people.' That way businesses, whether large or small, on the up and up or dishonest thieves, could offer and sell their pieces of paper to the world at large. To Congress, this brand new world of capital formation sounded like a great idea. To state regulators and investor protection advocates, it represents one of the worst ideas ever. The SEC had no choice. Under a congressional mandate to implement the new exemption for "public" private placements, the SEC has recently promulgated new rules, bifurcating Rule 506 into a private or "quiet" Rule 506(b) exemption and a public or "noisy" Rule 506(c) exemption permitting general solicitation of the entire population base so long as the purchasers are *verified* accredited investors. Because securities offered under Rule 506 exemption are deemed "covered securities," state regulatory authorities are precluded from applying the presale investor protection afforded by their own registration and exemptive schemes.[321]

In this Article, I have generally addressed the impact of Title II of the JOBS Act on state regulatory authorities as the SEC's partners in our country's dual regulatory system. I have provided a foundation for this analysis by first

319 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771, 44,771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242).

320 158 CONG. REC. S1719 (daily ed. Mar. 15, 2012) (statement of Sen. Landrieu) (quoting Letter from Jack E. Herstein, President, NASAA, Ass't Dir., Bureau of Sec., Neb. Dep't of Banking & Fin., to Harry M. Reid, Majority Leader, U.S. Senate & Mitch McConnell, Minority Leader, U.S. Senate (Mar. 12, 2012)).

321 *See supra* notes 93–94 and accompanying text.

describing the regulatory context in which the role of the states in protecting retail investors has been generally restricted through preemptive strikes at the authority of the states to regulate private offerings in their respective communities. Indeed, from my discussion of how NSMIA and JOBS Act preemption constrains the role of the states in providing early stage, presale protection of investors in unregistered private offerings of securities, one might conclude the states should simply yield the presale regulatory work to the SEC, even though that agency has traditionally looked the other way when it comes to private placements of securities.[322] Instead, in the final section of this Article, I conclude that the state regulatory authorities still have a vital role to play in filling this regulatory gap. First, they should enhance the newly expanded Rule 506 exemptions through monitoring and enforcing the rule's accompanying regulatory restrictions, thereby providing the early stage protection at the state level that has not been traditionally provided at the federal level. Through their enforcement of the federal exemptive scheme, the states would complement the federal scheme and further the cause of regulatory harmony in the protection of investors in our private placement marketplace. Second, I have encouraged the states, acting collectively through NASAA, to implement their own electronic one stop filing systems of Form D notices under Regulation D as soon as possible, linking the SEC's EDGAR system with a new NASAA administered EFD system for coordinated filing by issuers and their counsel. Finally, I have recommended that NASAA develop a bad actor database (BAD) that

322 Indeed, the SEC's Office of Inspector General (OIG) has found that the SEC's Division of Corporate Finance "does not generally take action when [it] learn[s] that issuers have not complied with the requirements of the Regulation D exemptions." OIG REPORT, *supra* note 206, at v. It further found that the SEC Division of Corporate Finance "does not substantively review the more than 20,000 Form D filings that it receives annually." *Id.* Moreover, the SEC has never sought, at least at the time of the *OIG Report*, any temporary, preliminary, or permanent injunctive relief from any court against an issuer for failure to file the Form D required by Rule 503(a) of Regulation D. *See id.* at 5. As a result of its study, the OIG specifically recommended that the SEC develop "a process to assess and better ensure issuers' compliance with Regulation D[, including] a periodic review of the Form D filings, an assessment of the accuracy and timeliness of the filings, and the identification of problems or 'red flags' with the filings." *Id.* at 12. The OIG further recommended that when the SEC's Division of Corporation Finance believes issuers have materially misused the Regulation D exemptions, it "should take appropriate action such as contacting the offenders, and/or referring the matter(s) to the Division of Enforcement, *the appropriate state regulator* or other regulatory authority." *Id.* (emphasis added). The SEC's response aptly illustrates its disdain for private placement regulation: "It does not appear that the Commission intended for the Form D notice to be a vehicle for detecting Regulation D violations or fraud or abuse in the sale of securities, nor that it intended for Form D to be a vehicle to provide disclosure to investors." *Id.* at app. VI, at 50. Yet the SEC continuously reaffirms the value of Form D review for enforcement purposes by state securities regulatory authorities stating that "the information in Form D filings has been useful for a number of . . . purposes, such as serving as a source of information for investors and facilitating the enforcement of the federal securities laws and the enforcement efforts of state securities regulators and FINRA." *See, e.g.*, Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 9416, Exchange Act Release No. 69,960, Investment Company Act Release No. 30,595, 78 Fed. Reg. 44,806, 44,810 (proposed July 24, 2013) (footnote omitted) (to be codified at 17 C.F.R. pts. 230 & 239).

is tailored to the data points set forth in the SEC's recently promulgated bad actor rule disqualifying issuers from using the Rule 506 exemption where the issuer and associated persons have adverse regulatory histories. The BAD system proposed would provide crucial assistance to bona fide issuers in screening their offerings and in satisfying their reasonable "factual inquiry" standard of care. Most importantly, it would allow retail investors to determine whether those offering the investment opportunities have clean regulatory histories. The new world of generally solicited private placements, exempt from both state and federal registration, presents vastly expanded challenges for the states in protecting their local investors. State regulatory authorities, however impeded by preemption, must continue to do what they do best, protecting investors in local securities markets before their losses are incurred.[323]

323 *See generally* Warren, *Dual Regulation*, *supra* note 14 (discussing the history of states protecting investors in securities markets).