Indiana Journal of Global Legal Studies

Volume 1 | Issue 2 Article 8

Spring 1994

Protection of Individual Investors Under U.S. Securities Laws: The Impact of International Regulatory Competition

J. William Hicks
Indiana University Maurer School of Law, hicks@indiana.edu

Protection of Individual Investors Under U.S. Securities Laws: The Impact of International Regulatory Competition†

J. WILLIAM HICKS*

Internationalization is the most significant development in the securities markets of the United States and many other countries. Until recently transnational market linkages have been limited primarily to North America, Western Europe, and Japan. Today, as a result of political change throughout the world, including the fall of the Iron Curtain and the Berlin Wall, and because of continuing technological advances in communication, a "global market economy" has actually materialized. With the disappearance of economic barriers, investors are experiencing new choices in the selection of financial services and investment instruments. The phenomenal growth in the complexity, volume, and availability of financial and investment products and services has prompted many new governmental and private controls of securities markets and securities transactions. Not surprisingly, some of these regulations and constraints conflict. Striking a proper balance between the protection of investors and securities markets and the forces of a free market economy has produced an international regulatory competition with obvious economic benefits to those that succeed. The participants in this regulatory competition include private individuals and private organizations, such as stock exchanges, trade associations, business corporations, nation states and their authorized agencies or representatives, cooperative groups of nation states, such as members of the European Community, and signatories to the North American Free Trade Agreement, and international organizations such as the International Organization of Securities Commissions (IOSCO).

U.S. participants in the international regulatory contest face many challenges in their efforts to ensure that domestic issuers, market intermediaries, and investors remain competitive in transnational investment opportunities and cross-border securities transactions. In general, these

---

* C. Ben Dutton Professor of Law, Indiana University School of Law, Bloomington.

challenges necessitate a reassessment of the present domestic regulatory scheme. Diverse global regulations call into question U.S. securities law policies that tolerate multiple levels of governmental and private controls of our capital and trading markets. A more specific and fundamental challenge, and the one that is the focus of this article, stands at the threshold of such a reassessment. It calls for domestic regulators and other policy makers to determine where ordinary individual investors, as opposed to institutional and other sophisticated investors, fit within the hierarchy of interest groups who benefit from U.S. securities regulation. The issue seems especially important in view of recent efforts by U.S. regulators, principally the Securities and Exchange Commission (SEC or Commission), to reform securities law in ways that suggest that the goal of protecting ordinary individual investors has yielded in significance to the goal of ensuring vibrant and competitive U.S. securities and capital markets in the global economy.[1]

Strong arguments exist for preferring the interests of ordinary individual investors over other interest groups in any regulatory reform of U.S. securities laws. First, the origin and history of federal securities statutes are clear evidence that U.S. securities laws were intended to protect investors. As articulated by Congress[2] and the courts,[3] the mission of these federal statutes and of the SEC, the federal agency that was created to administer

---

1. *See infra* text accompanying notes 10-87.

2. *See, e.g.*, the preamble to the 1933 Act which states: "An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, Pub. L. No. 22, § 1, Ch. 38, 48 Stat. 74 (Preamble). Section 2 of the 1934 Act contains the following statement of purpose for the statute:

> For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principle security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions. . . .

Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (1988 & Supp. IV 1992).

3. *See, e.g.*, United Housing Foundation Inc. v. Forman, 421 U.S. 837, 849 (1975); Reves v. Ernst & Young, 494 U.S. 56, 60-61, (1990).

them, is to promote the public interest in orderly, free, and fair securities markets and to assure the protection of investors. There is no doubt that the intended primary beneficiaries of these laws were members of the public generally and not specialized groups within the securities industry. The Securities Act of 1933, the Securities Exchange Act of 1934, and the four other federal statutes which in the aggregate are often referred to as federal securities law, were designed to rectify the abuses that had occurred in the years leading up to the 1929 crash of the stock market and to restore investor confidence in the core tenets of the free enterprise system.[4] One might fairly argue that unless Congress decides to abandon the original objectives of these federal statutes, domestic reformers must honor and promote the "public interest" and "protection of investors" as the two dominant considerations in the operation and regulation of our securities markets. Second, the integrity of the U.S. securities markets is grounded on the perception by ordinary investors that securities law prohibits any participant in these markets to reap an unfair advantage. Domestic reform that makes it easier for certain segments of the investing public to realize profitable investment opportunities, or for unscrupulous individuals and firms to manipulate securities prices and to deceive ordinary investors, threatens the very heart of the capitalist system. In the opinion of some observers, including state securities administrators, many of the SEC's reforms during the past decade have been in response to items on an industry "wish list" and have failed to address concerns of the individual investor.[5]

On the other hand, a number of competing factors support a less prominent status for ordinary investors among interest groups seeking benefits under reformulated securities laws. First, institutional investors have access to all of the financial and securities markets, but ordinary investors have a more limited choice. In addition to the stock market, which has subsidiary markets for equity securities such as initial public offerings

4. The following six statutes form the basis for federal securities laws: Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa (1988 & Supp. IV 1992); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78ll (1988 & Supp. IV 1992); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a to 79z-6 (1988 & Supp. IV 1992); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbb (1988 & Supp. IV 1992); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1988 & Supp. IV 1992); and Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1988 & Supp. IV 1992).

5. *See, e.g.*, statement by Maureen Thompson, legislative director of the North American Securities Administrators Association on December 30, 1992, *in GSA Reform, Leftover Issues Said to Top Legislative Agenda*, 25 Sec. Reg. & L. Rep. (BNA) 48, 50-51 (Jan. 15, 1993).

and private placements, the principal financial markets in both primary and secondary transactions consist of the money market, the government securities market, the municipal securities market, the corporate debt market, and the derivative products markets. Arguably, ordinary investors should not object to diminished protection with respect to securities transactions in markets where their participation is limited or nonexistent.

Second, the nature of markets where ordinary investors do participate has changed dramatically in the past decades. For example, in 1975, American households dominated share holdings in the U.S. equity market with seventy percent of the total equities outstanding. As of 1990, institutional investors, such as investment companies, insurance companies, pension funds, and bank trust departments, held fifty-three percent of all equities.[6] The evidence suggests that the trend toward increased institutional ownership of equities will continue. Given the changes in direct ownership of securities by individual investors between the 1930s, when the basic federal securities statutes were enacted, and the 1990s, it seems appropriate for domestic reformers to recognize the growing institutionalization of the markets in reformulating securities laws.

Third, U.S. securities regulation depends heavily upon self-regulatory organizations (SROs), such as the stock exchanges and the National Association of Securities Dealers (NASD), which in part retain their effectiveness by serving the interests of their constituencies. The interests of SROs are important to the national economy. At times, however, these interests are incompatible with the interests of ordinary individual investors. Certain compromises that favor the interests of the SROs over those of ordinary individual investors are, therefore, both inevitable and desirable.

Finally, most of the substantive principles in U.S. securities law, which provide important protection to investors, are typically the toughest in the world. These regulations represent costs that many firms and investors, both domestic and foreign, find burdensome. U.S. standards of regulation are being challenged by increasing competition among the international securities markets. Unless U.S. policy makers are prepared to eliminate or modify current standards as part of a move toward internationalization of regulatory standards, domestic participants in the financial and securities markets will suffer economically. Therefore, one might argue,

---

6. U.S. Equity Market Structure Study, Exchange Act Release No. 30920 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,012, at 82,907 (July 14, 1992).

harmonization of standards is inevitable and, in order for it to be in accord with "the public interest," it will have to be achieved through diminished protection for ordinary investors.

Part I of this article explores the changing character of investor protection for ordinary individuals in the context of federal regulation of primary securities offerings, a market that always has included both sophisticated and unsophisticated investors. It examines this topic through the policy implications of statutory and administrative regulations that circumscribe registered public securities offerings, exempted private placements, and limited offerings of securities. Part II continues the exploration of investor protection and the proper measure to be accorded individuals who purchase and sell securities, but shifts the inquiry from the relative simplicity of restructuring securities law at the national level to the complexity of reformulating that law in response to, or in anticipation of, international regulatory competition. It reviews viable approaches to the global challenges to traditional U.S. securities law and recommends a response that continues to offer investor protection for ordinary individuals in markets and transactions where they face special risks.

I.

U.S. securities regulation is derived from federal and state statutes, from administrative interpretations of those statutes by the SEC, other federal agencies, and by state securities commissioners, and from judicial constructions of legislative and administrative pronouncements. The combined body of law offers protection to the investing public by regulating companies (issuers) that offer securities for purchase and that allow a trading market in those securities to develop. Investor protection is achieved by means of mandated periodic disclosure by the issuer and certain key insiders or affiliates of the issuer,[7] by registration and regulation of market intermediaries, such as stock exchanges[8] and broker-dealers,[9] and by administrative and judicial sanctions against any investor who violates the

7. Periodic reporting by issuers is regulated by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(a), 78o(d) (1988); periodic reporting by affiliates and key insiders is dictated by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d) and 78p(a) (1988).

8. Securities Exchange Act of 1934, 15 U.S.C. §§ 78f, 78k, 78q, and 78gg (1988 & Supp. IV 1992).

9. Securities Exchange Act of 1934, 15 U.S.C. §§ 78o and 78q (1988 & Supp IV 1992).

substantive principles of securities law including the statutory registration and antifraud provisions. The level of protection that domestic securities law accords ordinary investors, typically individuals, as opposed to institutional and other sophisticated investors, has not remained constant during the past sixty years of federal legislation in this area. The following discussion examines one area of federal regulation—the offer and sale of securities by an issuer to members of the public—a market where individual investors always have participated and where standards of regulation are being challenged by international competition for capital markets. The purpose of this survey of federal law as it applies to issuer offerings is simply to demonstrate one example of a shift in emphasis in investor protection that has occurred in U.S. securities regulation and to suggest that similar transformations are occurring in other areas of securities law. It is not intended as a commentary on the wisdom behind such changes. Part II examines the normative dimension of this issue in the broader context of the adaptation of domestic securities law standards by U.S. policymakers in the face of global regulatory competition.

A. The 1933 Act

Issuer offerings of securities are regulated primarily by the Securities Act of 1933. Section 5 of that statute protects prospective purchasers of securities by requiring the seller to provide them "full and fair disclosure of the character of securities" to be sold.[10] Under Section 5, no person may offer or sell securities to the public until it complies with a registration procedure that calls for the filing of a registration statement, including a disclosure document referred to as a "prospectus," with the SEC.[11] As contemplated by Congress, the SEC staff is to review and correct all deficiencies in the documents filed by the registrant prior to the effective date of the registration statement. Finally, Section 5 contemplates that a copy of the prospectus, as corrected to reflect SEC staff comments and any material changes of fact that have occurred during the registration period, be given to each investor prior to sale, or in some cases, at the time of delivery of the security after sale.

10. Securities Act of 1933, 48 Stat. 74 (Preamble).
11. Securities Act of 1933, 15 U.S.C. § 77e, 77j (1988).

Congress, however, did not intend for the registration and prospectus delivery obligations of Section 5 to reach every securities transaction by an issuer or other participant in the securities markets. Sections 3 and 4 of the 1933 Act provide the legislative relief.[12] Of particular interest to issuers are the so-called transactional exemptions in the statutory provisions which permit an issuer to offer and sell unregistered securities under circumstances where, for a variety of reasons, Congress believed that full compliance with Section 5 was unnecessary.[13] In order to qualify for one of these exemptions the issuer must prove that it has satisfied all of the conditions.[14] Even where a transactional exemption is available, the issuer is still subject to the antifraud provisions of the 1933 and 1934 Acts.

Section 3(a)(11) exempts intrastate offerings by any issuer organized and doing business in the state where it plans to distribute its securities.[15] The offering must be restricted to persons residing in that state. The intrastate exemption, as Section 3(a)(11) is sometimes called, is but one of the transactional exemptions that the 1933 Act provides. Issuers can also consider a limited offering exemption under Regulation A[16] or under Rule 504[17] or Rule 505[18] of Regulation D. Section 3(b) of the 1933 Act is the source for these transactional exemptions.[19] It authorizes the SEC to create additional exemptions if it finds that registration is not necessary for the protection of investors "by reason of the small amount involved or the limited character of the public offering." In the case of Regulation A offerings, investor protection at the federal level comes from conditions that define the issuer as worthy, mandate the delivery of an offering circular

12. 15 U.S.C. §§ 77c, 77d, respectively (1988 & Supp. IV 1992).

13. Congress distinguished between exempted securities and exempted transactions. Sections 3(a)(2) through 3(a)(8) of the 1933 Act provide exemptions which turn on the intrinsic nature of the issuer or the character of the security itself. As a result, these exemptive provisions eliminate the need to determine whether the exempted securities are being sold publicly or privately or whether the person selling them is an issuer, underwriter, or dealer. The other subparagraphs of Section 3 and all of Section 4 identify certain transactions where Congress determined an exemption from Section 5 was appropriate, provided that all of the conditions of an exemption are satisfied. As a practical matter, most unregistered securities offerings are structured to comply with one or more of the transactional exemptions.

14. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 702 (9th Cir. 1938).

15. 15 U.S.C. § 77c(a)(11) (1988).

16. 17 C.F.R. §§ 230.251-.263 (1993).

17. 17 C.F.R. § 230.504 (1993).

18. 17 C.F.R. § 230.505 (1993).

19. 15 U.S.C. § 77c(b) (1988).

prior to sale, and limit the amount of an offering to $5 million.[20] Rule 504 of Regulation D is restricted to relatively small issuers (i.e., those that are not subject to the periodic reporting requirements of the 1934 Act) which do not qualify as investment companies or blank check companies and which offer and sell no more than $1 million of securities annually pursuant to the Section 3(b) exemption.[21] The "limited character" of a Rule 505 offering is retained by conditions which the exemption imposes on disclosure, manner of offering, the number and quality of purchasers, resale of securities by investors, and by a ceiling of $5 million on the amount of securities that can be offered annually under Section 3(b).[22] Finally, issuers can avoid the requirements of registration under the 1933 Act by qualifying an offering of unregistered securities under Section 4(2), the private placement exemption. Section 4(2) exempts "transactions by an issuer not involving a public offering."[23] According to the U.S. Supreme Court, Section 4(2) is limited to issuer offerings that are made to persons who do not need the protection of registration.[24] Because of the uncertainty surrounding judicial interpretations of Section 4(2), the SEC adopted Rule 506 of Regulation D as a non-exclusive safe harbor for issuers seeking to rely upon Section 4(2).[25] Like Rule 505 of Regulation D, Rule 506 contains limitations on disclosure, manner of offering, the number and quality of purchasers, and the resale of securities sold pursuant to the exemption. Unlike Rule 505, Rule 506 does not restrict the amount of money that an issuer may raise in a transaction.[26]

Federal regulation of the offer and sale of securities by issuers has evolved since 1933. The statutory scheme of registration and exemption, as provided for by Sections 3, 4, and 5 of the 1933 Act, has been supplemented by judicial interpretations of these provisions and a series of administrative rules that began in the 1970s and has continued to the present. Some SEC interpretations of these provisions have proven more successful than others. In many instances where the SEC has liberalized

---

20. *See generally* 7A J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, ch. 5 (rev. ed. 1993) [hereinafter HICKS].

21. *See generally id.*

22. *See id.*

23. 15 U.S.C. § 77d(2) (1988).

24. SEC v. Ralston Purina Co., 346 U.S. at 124-25.

25. 17 C.F.R. § 230.506 (1993).

26. *See generally* 7C HICKS, *supra* note 20, ch. 11.

standards of regulation and made it easier for an issuer to satisfy conditions or limitations of an exemption, investors sustained a reduction in protection. The easier it becomes for issuers to prove compliance with the terms and conditions of a transactional exemption, the more difficult it becomes for purchasers to invoke the protections of Section 12(1) of the Act. Under this civil liability provision, which is discussed in more detail below, investors have a statutory rescission right for one year following a purchase against any seller who is unable to sustain the burden of proof that its transaction was exempted from Section 5.[27] Interpretations of Section 12(1) by courts, including the U.S. Supreme Court, have further reduced the level of protection that ordinary investors previously enjoyed.[28]

The following assessment of investor protection for individual investors under these judicial and administrative interpretations does not proceed chronologically. Instead, it contrasts earlier regulations, which legislative history, judicial opinions, or SEC releases signalled as important for ordinary investors with regulations that currently apply to registered and unregistered issuer offerings. The assessment is organized by categories of regulation which have undergone material alteration in the regulation of primary offerings over time: (1) restrictions based on the nature and quantity of investors; (2) disclosure obligations; (3) limitations on the manner of sale; (4) restrictions on the resale of securities; and (5) private rights of action.

B. Nature and Quantity of Investors

Registered public offerings by issuers are available to all investors regardless of sophistication, wealth, or experience. In this respect, federal securities law has not changed since the enactment of the 1933 Act. However, the conditions as to the number and eligibility of investors under two of the transactional exemptions, Section 3(a)(11) and Section 4(2), have been liberalized significantly.

Section 3(a)(11) has never contained a disclosure obligation as a condition for exemption from Section 5. However, judicial and administrative interpretations of the intrastate exemption require the issuer to limit its distribution of unregistered securities to persons who are residents of the state where the issuer conducts a predominant amount of its

27. 15 U.S.C. §§ 77*l*(1), 77m (1988).
28. *See infra* text accompanying note 81.

business.[29] The legislative history of this provision is sparse, but it suggests that by so restricting the transaction to residents of the state where the issuer's principal business activities are located, the exemption can be claimed for offerings only in those situations where local offerees and purchasers are in a position personally to investigate the issuer and its operations. Furthermore, because the offering is restricted to residents of a single state, protection is readily available from that state's securities commissioner who, because of the provision's residency requirement for the issuer, is in a position to institute enforcement action against the issuer and its officers and directors and, where necessary, to seize business assets of the issuer for the benefit of investors.

Early judicial and administrative interpretations of Section 3(a)(11) interpreted residence, for purposes of the offeree and purchaser residency requirement, to mean domicile. In other words, a person was eligible to participate in a Section 3(a)(11) offering only if the issuer could prove that the person intended to make his location within the state his permanent place of abode.[30] In 1974, with the adoption of Rule 147, a safe harbor rule for Section 3(a)(11), the SEC abandoned this narrow, subjective test of residency for offerees and purchasers in favor of a broader and more pragmatic approach.[31] Under Rule 147(d)(2), an offeree or purchaser qualifies as a resident for purposes of Section 3(a)(11) if he or she spends more time each year in that state than in other parts of the world.[32]

In its 1953 opinion in *SEC v. Ralston Purina*,[33] the U.S. Supreme Court construed the private placement exemption, which is set forth in Section 4(2), as imposing limitations on both offerees and purchasers. It also rejected any numerical limitation on the scope of the exemption, saying that an offering to a few or to many might qualify as public and, therefore, outside the scope of the provision.[34] According to *SEC v. Ralston Purina*, an offering is nonpublic if it is limited to persons who can "fend for themselves."[35] Informally, this limitation is construed as restricting Section 4(2) offerings to sophisticated investors, an equally ambiguous term. During

29. *See generally* 7 HICKS, *supra* note 20, ch. 4.
30. *See id.* § 4.05[1][b][i].
31. *See id.* § 4.05[2].
32. *See id.* § 4.05[2][b].
33. 346 U.S. 119 (1953).
34. *Id.* at 125.
35. *Id.*

the early 1970s, Section 4(2) was subject to restrictive interpretations by both the courts and the SEC.[36] It was generally assumed then that very few individuals possessed the knowledge and experience to assess the risks and merits of a prospective investment that fending for oneself appeared to entail. Because the eligibility requirement of Section 4(2) extended to offerees and purchasers, an issuer planning a private placement was well advised to restrict its offering to institutions or to limit the number of individuals to a few.[37] In 1982, with the adoption of Regulation D,[38] the SEC revitalized the private placement exemption and in the process reinterpreted the group of persons who are deemed to have the capabilities to fend for themselves. In crafting more expansive guidelines for Section 4(2), the Commission also abandoned a limitation on issuers that it had successfully urged on the Supreme Court. Under Rule 506 of Regulation D, an issuer prior to making offers is no longer obligated to make a subjective determination that each offeree is eligible.[39] Contrary to the Supreme Court's opinion in *Ralston Purina*, everyone may be considered a potential Rule 506 offeree. Rule 506 shifts the focus from the status of each offeree to the sophistication of each purchaser. Furthermore, the class of eligible purchasers is broadened with a definition of "fend for himself" that gives an issuer two choices. A purchaser is presumed to be able to fend for himself if he qualifies as an "accredited investor,"[40] a term that is defined in Rule 501(a) of Regulation D by objective criteria to include specified institutions and certain individuals in positions of influence within the issuer or in positions of economic independence. Because the term "accredited investor" is incorporated into Rule 506, an issuer is relieved from the need to make subjective judgments about the suitability of such persons. Alternatively, a person is an eligible purchaser in a Rule 506 private placement if, in the reasonable belief of the issuer, he has such knowledge and experience in financial matters that he is capable of evaluating the risks

36. *See, e.g.*, SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). *See also* 7C HICKS, *supra* note 20, § 11.08[3][c].

37. *See* Harold Marsh, Jr., *Who Killed The Private Offering Exemption?*, 71 NW. U. L. REV. 470 (1976).

38. Sec. Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

39. *See* 7C HICKS, *supra* note 20, § 11.08[4][a].

40. 17 C.F.R. § 230.506(b)(2)(ii) (1993).

and merits of the prospective investment.[41] The SEC's decision to protect purchasers and not offerees is reflected again in the elimination of any concern about the number of offerees to whom the issuer may direct its offering. Rule 506 permits offers to everyone and sales to an unlimited number of accredited investors and to thirty-five nonaccredited investors who otherwise satisfy the traditional subjective standard of sophistication.[42]

Thus, in the liberalization of both Section 3(a)(11) and Section 4(2), the SEC has affected investor protection in two respects. First, the objective interpretations of the residence requirement in Rule 147 and the eligibility requirements of Rule 506 expand the intrastate and private placement exemptions to permit offerings of unregistered securities to persons who would not have qualified under earlier interpretations. Second, these administrative rules reduce the burden of proof for the issuer in the event of a Section 12(1) rescission suit by purchasers.

C. Disclosure Obligations

As noted earlier, registration under the 1933 Act contemplates the preparation and delivery of a disclosure document, called a prospectus, to offerees and purchasers in a public offering. During the period of time between the filing of the registration statement with the SEC and the date when it becomes effective, a period lasting about two months, the issuer and its agents may not sell securities. But during this waiting period, oral offers are permitted and written offers in the form of the incomplete preliminary prospectus are allowed. Once the registration statement is declared effective, a copy of the final prospectus must be delivered to each purchaser prior to or in conjunction with the sale or, in the event of an oral sale, prior to or in conjunction with the mailing of the confirmation or the security. The prospectus delivery obligation is imposed on all broker-dealers, regardless of their participation in the selling effort, for a fixed period of time that was designed to approximate the duration of the average public offering.

Four aspects of the disclosure requirements for issuers selling registered securities are worthy of notice in evaluating the degree of protection that they afford investors. First, although Congress intended the prospectus delivery duties to extend to all registered offerings, it authorized the

41. *Id.*

42. 17 C.F.R. §§ 230.501(e)(1)(iv) and 230.506(b)(2)(i) (1993).

Commission to modify or eliminate them in situations where, in its opinion, personal copies of the prospectus were unnecessary.[43] The SEC has eliminated the prospectus delivery obligations in several designated instances, including offerings by issuers that are subject to the periodic reporting requirements of Sections 13 or 15(d) of the 1934 Act.[44] In theory, 1934 Act registrants that make registered offerings are already providing the public securities markets with adequate ongoing disclosure about themselves so that the delivery of a statutory prospectus to purchasers is thought to be superfluous. In practice, some investors in a 1934 Act registrant will be unfamiliar with certain aspects of information about that company, but because of the SEC's dispensation from the prospectus delivery duties these investors will not be furnished with the disclosure contained in the 1933 Act registration statement.

Second, even if the issuer and the market intermediaries are subject to the prospectus delivery obligations of Section 5, there is no guarantee that an investor will receive the prospectus prior to the time when he or she makes an investment decision to purchase. Section 5 permits delivery of the prospectus after the sale when the issuer or its agent mails to the purchaser a written confirmation of the transaction or the security itself.[45]

Third, issuers preparing a registration statement must be concerned with both the content of the document to be filed with the SEC and the standard of disclosing that information. The SEC has prepared forms that specify the items of information that must be included in a registration statement.[46] How that information is disclosed is another issue. The SEC has regularly stated that information in a registration statement is intended not for the securities professional, but for the "ordinary reasonable investor."[47] Despite the ambiguity of this term, the Commission has never attempted to define it. Given the complexity of certain businesses and the highly technical nature of certain items of disclosure on the SEC registration

---

43. 15 U.S.C. § 77d(3)(B) (1988). *See generally* 7C HICKS, *supra* note 20, § 12.05. The statutory period during which the dealer is obligated to deliver a prospectus may be shortened or eliminated if the Commission determines that it is unnecessary for the protection of certain investors. *Id.* § 12.05[1].

44. 17 C.F.R. § 230.174(b) (1993).

45. 15 U.S.C. §§ 77b(10)(a) (any prospectus confirming the sale of any security) and 77e(b)(1) and (2) (1988).

46. *See generally* 2 Fed. Sec. L. Rep. (CCH) ¶ 6011 (May 24, 1993).

47. *See, e.g.*, In re Universal Camera Corp., 19 S.E.C. 648, 649, 654 (1945).

forms,[48] issuers frequently find this standard of disclosure to be especially challenging. From time to time the SEC has sought to reduce the legalese and boilerplate in prospectuses and to make them easier for "ordinary reasonable" investors to read. For a while the Commission required issuers to use charts and diagrams to illustrate certain technical information, such as dilution,[49] and it continues to insist on the use of a one-page summary of the prospectus at the outset of the document.[50] Despite these efforts, much of the disclosure in 1933 Act prospectuses is incomprehensible to unsophisticated investors.

Fourth, 1933 Act prospectuses do not contain all of the information about an issuer that is critical for intelligent investment decisions. For more than thirty years, the SEC took the view that the information contained in a registration statement should be hard, historical data that could be objectively verified. Soft, forward-looking information, such as sales forecasts or income projections, was unacceptable[51] even though market professionals insisted that issuers provide them with this type of disclosure. The Commission has altered its stance on this point, but because it will not provide issuers that disclose forward-looking information in a prospectus with an impregnable defense to claims of misrepresentation by investors who contend that they were fraudulently misled by such disclosures, issuers are reluctant to volunteer such data in their 1933 Act filings and the Commission does not mandate that they do so.[52] Thus, those market professionals and investors who are positioned to receive such material information achieve an investment advantage over the ordinary, reasonable investor who only receives a copy of the final prospectus.

---

48. *See, e.g.*, item 101 of Regulation S-K, which is incorporated into the basic registration form, Form S-1, item 11. 2 Fed. Sec. L. Rep. (CCH) ¶ 7123 (Apr. 7, 1993).

49. RICHARD W. JENNINGS & HAROLD MARSH, JR., SECURITIES REGULATION CASES AND MATERIALS 139-43 (5th ed. 1982).

50. *See* item 503 of Regulation S-K, Form S-1, item 3. 2 Fed. Sec. L. Rep. (CCH) ¶ 7123 (Apr. 7, 1993).

51. *See, e.g.*, Sec. Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978) (Commission explains its traditional opposition to soft information in registration statements in the announcement of a revised policy).

52. The SEC has adopted a safe-harbor rule for issuers that disclose forward-looking information but it does not provide them with total protection from civil liability. *See* 17 C.F.R. § 230.175 (1993). An issuer of registered securities faces almost absolute liability to purchasers under section 11 of the 1933 Act for any material misstatements in the registration statement at the time it became effective. 15 U.S.C. § 77k(a)(1) (1988). An issuer also faces civil liability for material misstatements under Rule 10b-5. *See* 17 C.F.R. § 240.10b-5 (1993).

Protection through disclosure does not come with every transactional exemption. Where an issuer structures its unregistered offering to satisfy the requirements of the intrastate exemption under Section 3(a)(11), the issuer is not required to give investors a disclosure document. Rule 504 permits certain small issuers to raise $1 million annually in a public offering of securities with no disclosure obligations. For several years, the absence of disclosure in Rule 504 transactions was balanced by conditions that prohibited general advertising and general solicitation and that restricted resales for two years after the offering. In 1992, the SEC eliminated these conditions from Rule 504, but continued to allow public offerings without any mandated disclosure.[53] Rule 505 and Rule 506 of Regulation D impose disclosure obligations on the issuer, but only with respect to purchasers who are not accredited investors. Nonaccredited purchasers are persons who are sufficiently sophisticated to qualify as eligible purchasers under Rule 506, but do not possess the skill, knowledge, or bargaining power to demand all of the information that should be reviewed prior to an investment decision. In order to protect such persons, the issuer in a Rule 505 or Rule 506 transaction must furnish each nonaccredited purchaser with a disclosure circular that contains "[t]he same kind of information" that would appear in a registration statement.[54] Accredited purchasers are presumed to have the capability to force the issuer to share with them whatever information they need and, therefore, they are not entitled to receive a disclosure statement under these exemptions. As noted earlier, the categories of accredited investors are broad enough to encompass persons who are not necessarily able to fend for themselves. Purchasers in a Regulation A offering receive a disclosure document that resembles a statutory prospectus in a registration statement. The shortcomings of prospectuses in registered offerings apply equally to the mandated disclosure in Regulation A distributions.

53. Sec. Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72, 439 (July 30, 1992) [hereinafter Sec. Act Release No. 6949] (adopted); Sec. Act Release No. 6924, [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,931 (Mar. 11, 1992) (proposed).

54. 17 C.F.R. § 230.502(b)(2)(A) (1993).

D. Limitations on Manner of Sale

Where securities are to be sold pursuant to an effective registration statement, the issuer may not commence promotional efforts until the registration statement has been filed and a preliminary prospectus is available. Congress decided that during this prefiling period an issuer should not be able to condition the securities market for its forthcoming offering.[55] Courts and the SEC have generally honored this legislative prohibition against advertising and solicitation in the time period leading up to the registration process. They do so out of fear that investors might be tempted by gun-jumping activities by the issuer to form a premature opinion about the prospective securities issue without the benefit of the full disclosure of material information, favorable and unfavorable, in the prospectus.[56] The one major qualification, which is dictated by the realities of modern corporate life, is that during the prefiling period issuers are permitted to disseminate to the public at large such factual information as they have regularly released in the past.[57] For example, an issuer that regularly sends reports to its shareholders may continue to disclose such information to them even though it is about to file a registration statement with the SEC. Well-established companies which are in constant communication with shareholders, securities analysts, and stock exchanges, enjoy an advantage in the prefiling period that some smaller, less developed issuers do not possess. For certain registered offerings, this gap in the wall of silence that Section 5 imposes on prefiling publicity could prove to be significant.

When an issuer plans to sell unregistered securities it might find that the exemption it seeks to invoke requires that no offer to sell securities can be made through any form of general solicitation or general advertising. When an exemption contains this prohibition, issuers are unable to engage in the mass recruitment of prospective purchasers that is permitted in a registered

55. Section 5(c) of the 1933 Act prohibits any offeror to sell a security until a registration statement has been filed with the SEC. 15 U.S.C. § 77e(c) (1981). Section 2(3) of the 1933 Act defines "offer to sell" as including every attempt to dispose of a security for sale. 15 U.S.C. § 77b(3).

56. *See, e.g.*, Chris-Craft Industries, Inc. v. Bangor Punta Corp., 426 F.2d 569, 574-76 (2d Cir. 1970); S.E.C. v. Arvida Corp., 169 F. Supp. 211 (S.D.N.Y. 1958); In re Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 850-53 (1959).

57. *See, e.g.*, Sec. Act Release No. 5180, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192 (Aug. 16, 1971).

public offering after a registration statement has been filed with the SEC. Unlike the offerees in a registered offering, prospective purchasers in unregistered offerings are not entitled to receive a statutory prospectus that has undergone SEC staff review and criticism prior to the time that any sales are permitted. Furthermore, investors in unregistered offerings are not protected by the civil liability provision in Section 11 of the 1933 Act. The provision imposes almost absolute liability on the issuer of securities that are the subject of a registration statement which contained a misstatement of material fact at the time it became effective.[58] Because investors in unregistered offerings do not enjoy these protections of registration, the Commission has used certain limitations to safeguard members of the public, especially the unsophisticated and inexperienced, from persons who might otherwise exploit the opportunity to sell them unregistered securities. The limitations chosen by the Commission include prohibitions against general solicitation and general advertising in transactional exemptions.

Section 3(a)(11) does not require the issuer to provide prospective investors with prescribed disclosure and for that reason, presumably, it places no limitations on the manner of offering.[59] Regulation A also exempts public offerings, but it resembles a registered offering by requiring the filing of a simplified disclosure statement with one of the SEC's regional offices and the delivery of copies of that statement to investors. Originally, Regulation A prohibited any offers by the issuer or persons acting on its behalf prior to the time that the prescribed offering circular had cleared regional staff review. In 1979, the Commission amended Regulation A to allow certain issuers to distribute a preliminary offering circular prior to the commencement of formal selling.[60] In 1992, in an attempt to make the exemption even more attractive to issuers, the SEC liberalized Regulation A further by permitting issuers to "test the waters" by general solicitation prior to any filing with the regional office.[61] This amendment permits issuers to determine whether the market is interested in an offering before embarking on the time-consuming and expensive process of preparing the

58. 15 U.S.C. § 77k (1988) (providing for civil liability on account of a false registration statement).

59. *See, e.g.*, Sec. Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2276 (Dec. 6, 1961).

60. Sec. Act Release No. 6075, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,101 (June 1, 1979).

61. Sec. Act Release No. 6949, *supra* note 53, at 62,169.

mandated offering statement.[62] Not even issuers that are considering a registered offering are granted this much flexibility during the pre-filing stage of a transaction. Rule 504 is a third transactional exemption that permits offerings to the public at large. Like the Section 3(a)(11) exemption, Rule 504 is not conditioned on the disclosure of information to investors. But unlike Section 3(a)(11), Rule 504, as adopted, proscribed general advertising and general solicitation. In 1992 the SEC removed this limitation on the manner of offering securities.[63]

Rules 505 and 506 continue to prohibit the use of general solicitation and general advertising. However, in a series of interpretative letters, the SEC staff has determined that the prohibition does not extend to "limited" solicitation and "limited" advertising.[64] As articulated in administrative correspondence with attorneys for prospective issuers, "limited" solicitation and "limited" advertising consists of communications between the issuer or its agent and any person with whom the issuer or its agent has a pre-existing relationship that permits the offeror to know that the offeree is a sophisticated or an accredited investor. As a result of these guidelines, an issuer or a person acting on its behalf, such as a broker-dealer, can create a pool of prospective investors prior to the time that a disclosure document is available for offerees to inspect.

E. Resale Restrictions

Securities that are sold in registered public offerings may be resold immediately in any manner and in any amount by any person who is not deemed to be an affiliate of the issuer. Persons who are in control of the issuer are considered affiliates and may resell registered securities immediately, but only in quantities that do not represent another public offering. As designed by Congress, Section 5 regulates public offerings by affiliates in the same way as distributions by the issuers. Consequently, the 1933 Act contemplates restrictions on the resale of registered securities only when the seller is an affiliate and when the volume is deemed to be significant.[65]

---

62. *See generally* 7A HICKS, *supra* note 20, § 5.07[1][b].
63. Sec. Act Release No. 6949, *supra* note 53, at 62,170.
64. *See* 7A HICKS, *supra* note 20, § 7.03[4][a].
65. *See generally* 7B HICKS, *supra* note 20, § 9.03[4].

Resale restrictions can also arise out of a transaction in which unregistered securities are sold. Transactional exemptions contain one or more limitations. Section 3(a)(11) offerings are limited to residents, Rule 505 offerings are subject to the restriction of Section 3(b), which provides for a limited public distribution, and Section 4(2) offerings, with or without Rule 506, must be non-public. In order to ensure the limited nature of an offering under these exemptions, the issuer is expected to take precautions against premature resales by original purchasers. Purchasers in a Section 3(a)(11) offering, for example, may not immediately resell to nonresidents. Otherwise, a purported intrastate offering would become in reality an interstate offering, a transaction which Section 3(a)(11) does not exempt. Similarly, qualified purchasers in a Rule 506 offering may not resell immediately to unqualified purchasers. Otherwise, an issuer could use Section 4(2) or Rule 506 to engage in a two-step public offering, a transaction for which these exemptions are not available. In both instances, as well as in Rule 505 transactions, the SEC has required purchasers to hold the securities they purchased for a fixed period of time prior to reselling to the public. The holding period requirement that attaches to each of these exemptions is designed to prevent an allegedly limited offering from spilling over to persons who need the protections of registration and disclosure. Securities subject to resale limitations imposed by the issuer are sometimes referred to as restricted securities.

There are, then, two classes of persons who face resale limitations. First, affiliates who hold registered securities or other unrestricted securities must avoid resales that resemble public offerings. Second, affiliates and nonaffiliates who hold restricted securities may not resell until after they have held these securities for a period of time.

The SEC adopted Rule 144 to help persons faced with resale limitations.[66] The Rule provides objective guidelines that explain how and when such persons may resell their securities to the public. It is conditioned upon the availability of current and reliable information about the issuer, which the issuer must publish on a regular basis,[67] and upon the resale of the securities in a brokerage transaction.[68] Rule 144(d) addresses the issue

66. 17 C.F.R. § 230.144, which was adopted in Sec. Act Release No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487 (Jan. 11, 1972).

67. 17 C.F.R. § 230.144(c) (1993).

68. 17 C.F.R. § 230.144(f) (1993).

of how long restricted securities must be held prior to resale by imposing a two year holding period.[69] Rule 144(e) fixes the volume of securities that may safely be resold and not constitute a public offering.[70] Paragraph (e) thereby assists affiliates who hold restricted and unrestricted securities and nonaffiliates who hold restricted securities. Like other administrative rules, Rule 144 has been the subject of liberal revision. In a series of amendments to Rule 144 since its adoption in 1972, the SEC has relaxed the holding period requirement[71] and increased, and in certain situations eliminated, the resale volume limitations.[72] It also added, by amendment, Rule 144(k), which permits nonaffiliates who have held restricted securities for a period of three years to resell publicly without any limitation on the volume or the manner of resale and regardless of the general availability of public information about the issuer.[73]

Securities sold pursuant to the intrastate exemption are technically not restricted securities, as defined by Rule 144(a)(3), and therefore are not subject to the holding period requirements of Rule 144(d). But these securities are subject to resale limitations of a different sort. Section 3(a)(11) requires not only that the securities be offered and sold in a single state, but also that they come to rest in the hands of persons residing within the state.[74] Judicial interpretations of Section 3(a)(11) have made it clear that when a single resident-purchaser makes a reoffer or resale to a person outside the state prior to the time that the offering has come to rest, the issuer loses its exemption, despite good faith efforts to control the offering.[75] An issuer that is unable to prove the availability of an exemption for its unregistered offering is liable in rescission under Section

69. 17 C.F.R. § 230.144(d)(1) (1993).

70. 17 C.F.R. § 230.144(e) (1993).

71. Sec. Act Release No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (Apr. 23, 1990).

72. *See* Sec. Act Release No. 5979, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,731 (Sept. 19, 1978); Sec. Act Release No. 5995, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,759 (Nov. 8, 1978).

73. 17 C.F.R. § 230.144(k), which was added to Rule 144 in Sec. Act Release No. 6286, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,821 (Feb. 6, 1981). It was liberalized by Sec. Act Release No. 6488, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,429 (Sept. 23, 1983) and by Sec. Act Release No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (Apr. 23, 1990).

74. Sec. Act Release No. 1459, 1 Fed. Sec. L. Rep. (CCH) ¶ 2261 (May 29 1937).

75. *See, e.g.*, Capital Funds, Inc. v. SEC, 348 F.2d 582, 586 (8th Cir. 1965); SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal. 1960).

12(1) to all persons who purchase securities from it. Until 1974 when the SEC adopted Rule 147 as a safe harbor rule for Section 3(a)(11), it was generally assumed that the resident purchasers were required to wait one year from the date of the last sale in the intrastate offering before reselling to a nonresident.[76] Information about the issuer, which is not required in a primary intrastate offering, has never been required as a condition for resale in the secondary market. In Rule 147(e), the SEC reduced the period of time that resident purchasers must wait before reselling to nonresidents from twelve to nine months after the last sale of securities in the primary distribution area.[77]

Rule 504 permits nonreporting companies to sell one million dollars of securities publicly each year without any disclosure. As adopted, this exemption required the issuer to take precautions to ensure that purchasers did not resell for at least two years following the sale. Because securities sold in Rule 504 offerings were considered restricted for purposes of Rule 144, resales after two years were possible under Rule 144 only if the issuer complied with the information requirements of Rule 144(c). In 1992, the SEC amended Rule 504 and removed this limitation.[78] Today, purchasers in a Rule 504 offering may resell without any holding period, regardless of whether the issuer has provided the secondary trading market with the type of information that Rule 144(c) requires.

F. Private Rights of Action

The fundamental purpose of the federal securities laws is to ensure full and fair disclosure and to protect investors from fraud in the public offering, trading, voting, and tendering of securities. Private rights of action are an important enforcement tool for the registration and antifraud provisions of the 1933 and 1934 Acts.

Section 12(1) of the 1933 Act provides the only basis for a private action for rescission or damages against a seller who has offered or sold securities in violation of the registration requirements. In order to prevail in a Section 12(1) claim, a purchaser is required to prove only that (1) a

76. The one year period was first suggested by the SEC in Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 163 (1935). *See also* Myer v. E.M. Adams & Co., 519 P.2d 375, 376 (Ore. 1974).

77. 17 C.F.R. § 230.147(e) (1993).

78. Sec. Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72, 439 (July 30, 1992).

registration statement covering the securities was not in effect, (2) the defendant offered or sold the securities to the plaintiff, (3) the requisite jurisdictional means were employed, and (4) the suit was commenced in a timely manner.[79] The burden of proof then shifts to the seller to prove that the offer or sale was exempted from Section 5.

As a protective weapon, especially for ordinary investors, Section 12(1) has been weakened by a series of judicial and administrative interpretations. Prior to 1988, most federal courts permitted a Section 12(1) claimant to seek relief from the issuer in a primary offering or from a collateral participant in the transaction, such as an officer, director, general partner, attorney or accountant, who was judged to be a substantial factor in causing the unlawful sale to occur.[80] However, in *Pinter v. Dahl*,[81] the Supreme Court narrowed the scope of potential defendants to a Section 12(1) claim. It decided that Section 12(1) liability extends only to the person who passes title to the security and to the person "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner."[82] Lower courts have relied upon *Pinter* to restrict Section 12(1) liability in most instances to the technical owner of the security.[83] Thus, as a practical matter, purchasers in an unregistered securities offering by the issuer will be limited to a claim against that seller and, even where the issuer is insolvent, they will no longer be able to reach the owners or principals.

SEC interpretations of transactional exemptions have also undermined the forcefulness of Section 12(1). In addition to liberalizing conditions of particular exemptions, the Commission has eased the issuer's burden of proving the availability of an exemption, first, by restating exemption limitations with objective standards, and second, by providing in many of the administrative rules that an issuer's reasonable belief that it has satisfied particular conditions will suffice.[84] Earlier constructions of the

---

79. *See generally* 17 J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT § 5.01 (Clark Boardman Callaghan Securities Law Series, rev'd ed. 1993) [hereinafter HICKS, CIVIL LIABILITIES].

80. *Id.* at §§ 5.04[2] and 6.03[4].

81. 486 U.S. 622 (1988).

82. *Id.* at 647.

83. *See generally* 17A HICKS, CIVIL LIABILITIES, *supra* note 79, at § 6.03[5].

84. *See, e.g.*, Rule 506(b)(2)(ii) which specifies the nature of purchasers that are permitted under the non-exclusive safe harbor rule for Section 4(2). Under the statutory exemption, an issuer is required to prove that every purchaser was in fact able to fend for himself or herself. But in claiming an

transactional exemptions that issuers usually invoke in primary offerings placed the issuer at risk under Section 12(1) if all of the exemption conditions were not met, even if the issuer had acted reasonably or in good faith. Finally, the SEC has amended Regulation A[85] and Regulation D[86] (under which Rules 504, 505, and 506 are subsumed) to provide issuers with a defense to a suit for rescission under Section 12(1). This administrative relief was added in response to critics of the traditional interpretations of transactional exemptions under which any failure by the issuer to satisfy the conditions of an exemption resulted in the loss of that exemption for the entire transaction and gives all of the purchasers in that transaction a cause of action for rescission under Section 12(1). Reformists criticized the severity of this view by pointing to certain offerings which were otherwise in complete compliance with an exemption, but lost the exemption as a result of an inadvertent failure to comply with some condition that was immaterial to the offering as a whole. Under the safe harbor rules that are now available to an issuer in an offering under Regulation A or Rules 504, 505, or 506 of Regulation D, an issuer's failure to comply with a term, condition, or requirement of one of these exemptions does not cause a loss of the exemption for any offer or sale to a particular individual or entity if the issuer can demonstrate that first, the term, condition, or requirement violated was not directly intended to protect the complaining party, second, the failure to comply was insignificant to the offering as a whole, and third, the issuer made a good faith and reasonable effort to comply with all the terms, conditions, and requirements. Although the safe harbor rules do not insulate an issuer from SEC enforcement action, they significantly reduce the potential liability that an issuer of unregistered securities faces under Section 12(1).[87]

Private rights of action against an issuer who engages in fraudulent sales activity as part of a primary offering can be brought under Sections 11 and 12(2) of the 1933 Act and under Rule 10b-5 of Section 10(b) of the 1934

---

exemption under Rule 506, an issuer must prove either that each purchaser satisfies the conditions of paragraph (b)(2)(ii), or that "the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." *Id.*

85. Sec. Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72, 439 (July 30, 1992). The safe-harbor rule for Regulation A is found in 17 C.F.R. § 230.260 (1993).

86. Sec. Act Release No. 6825, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989). *See* 17 C.F.R. § 230.508 (1993).

87. *See* 17 C.F.R. §§ 230.260 and 230.508 (1993).

Act. Judicial interpretations of these civil liability provisions, however, have reduced their effectiveness for investors.[88] The combined loss in effectiveness under these provisions and under Section 12(1) translates into a reduction in the level of deterrence against fraud and registration violations. Ordinary individual investors, who lack the sophistication, experience, and bargaining power that institutions use to help protect themselves, inevitably are the biggest losers.

G. Summary

This broad survey of five categories of regulation in primary offerings of securities that appear in the sections on Nature and Quantity of Investors through Private Rights of Action, parts I. B through I. F, supra, provides ample evidence that ordinary investors have less protection today than in earlier periods of SEC administration of the 1933 Act. Restrictions on the nature and quantity of investors under Sections 3(a)(11) and 4(2) have been relaxed. Disclosure in registered offerings, through the use of a statutory prospectus, is not required in all transactions and, where required, may occur after an investor has decided to purchase. Furthermore, the quality of disclosure in a prospectus, both in terms of content and manner of presentation, does not always assist unsophisticated investors. In unregistered offerings, an issuer can avoid any duties of disclosure by relying upon Section 3(a)(11) or Rule 504. Other transactional exemptions, such as Regulation A and Rules 505 and 506 of Regulation D require some form of disclosure by the issuer, but the benefits of this form of protection depend on when an investor makes an investment decision. All three of these exemptions permit the issuer to persuade offerees of the merits of an offering without the use of a disclosure document. Regulation A allows the issuer to "test the waters" prior to preparation of a disclosure document, while Rules 505 and 506 of Regulation D, which are unconcerned with offerees, require delivery of a disclosure document only where the purchaser fails to qualify as an accredited investor, a category that equates wealth with sophistication. Limitations on the manner of sale, once considered a necessary restraint on issuers in order for disclosure obligations to succeed, are being modified or withdrawn from securities law. Regulation A now

88. For a discussion of how investors have lost protection under Section 10b-5 see Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791, 808-10 (1993).

permits offers to any potential investor even before the issuer has decided to prepare a disclosure document. Rule 504 no longer contains a ban on general advertising and general solicitation. Under administrative interpretations of Regulation D, issuers in Rule 505 and 506 offerings may engage in advertising and solicitation provided that it is "limited." Resale limitations survive as protection against indirect public offerings by issuers or affiliates without disclosure of material information, but amendments to Rule 144 have undercut some of the effectiveness that these restrictions once possessed. Finally, private rights of action under Sections 12(1) and 12(2) of the 1933 Act are less potent today as weapons against registration violations and fraud. Safe-harbor rules adopted by the SEC give defendants to such lawsuits more protection and judicial interpretations of civil liability provisions have narrowed the scope of potential defendants and increased the burden of proof for investors bringing suit.

II.

As Part I demonstrates, ordinary investors in the market of primary offerings of securities have experienced a decline in protection as a result of judicial and administrative interpretations of various provisions of the 1933 and 1934 Acts. This reduction of investor protection was aided by a political climate that supported deregulation as the means for eliminating the financial woes of business, especially unseasoned companies seeking access to the capital markets. In recent years, it also has been spurred on by fears that U.S. regulatory policies were interfering with this country's ability to compete internationally in the financial and securities markets. The issue then is clear. As a preliminary matter, the problem is to determine how U.S. policymakers are to respond to the demands of international regulatory competition and whether the response necessarily entails a reduction in protection for ordinary investors. Assuming that ordinary investors must experience a decline in protection under federal securities law, the problem then is to decide whether that result is fair given the legislative goals of the federal securities statutes. Although these questions are relevant to all aspects of U.S. securities law, they are considered here only in the context of the 1933 Act as it applies to primary offerings of securities.

The registration and prospectus delivery obligations of Section 5 apply to foreign issuers which offer securities: within the United States, abroad under circumstances such that they are likely to flow back to the United

States, or in transactions that may be designed for foreign investors, but have a jurisdictional connection with the United States.[89] Of course, where Section 5 applies to a foreign issuer's offering, most of the transactional exemptions discussed earlier might be available as an alternative to filing a registration statement.[90] Foreign issuers which are confronted with the application of U.S. securities laws to their proposed offerings might choose to avoid selling securities in this country when the costs and burdens of the regulatory system in another nation's market are lower than those associated with the United States. Even domestic issuers in search of capital have this choice of regulation to consider in deciding where to market their securities. Foreign jurisdictions that offer efficient markets, but less onerous regulation than the United States, will have a competitive advantage over the United States; this will produce a loss of business for U.S. participants in the capital markets. In view of the world-wide competition among capital markets and among government regulatory policies, U.S. policymakers have several choices in deciding how to respond to international public offerings which, under domestic securities law, would have to be made pursuant to a registration statement, including:

(1) *Adhere to rigorous standards of disclosure and protection for investors*. This position assumes that U.S. regulatory policies are superior to those of foreign countries and that all investors are best served by having securities, including those issued by foreign firms, accurately priced and by having the best protection in place for both unsophisticated and sophisticated investors. Although U.S. securities laws are no doubt the toughest in the world, it is unclear whether toughness translates into superiority. Even assuming that U.S. securities laws are superior, it is not clear that any modification of standards or regulations applicable to public offerings would significantly alter their status. Certainly, the SEC has not been reluctant to reduce disclosure and registration exemption requirements during the past

89. The extraterritorial reach of U.S. securities laws, especially the 1933 Act, was the topic of Sec. Act Release No. 6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524 (Apr. 24, 1990).

90. Section 3(a)(11) is unavailable to foreign corporate issuers because it requires a corporate issuer to be incorporated in the state where the offering is to occur. Even where a foreign issuer is a noncorporate person, it would most likely fail the doing business requirement of Section 3(a)(11). Regulation A is also unavailable to any foreign issuer except one that is qualified as a Canadian issuer. *See* 17 C.F.R. § 230.251(a)(1) (1993).

twenty-five years. Indeed, all of the Commission's revised and amended rules are announced as "consistent with the protection of investors."

(2) *Maintain the current regulatory scheme but allow for ad hoc exceptions.* This approach introduces politics into the regulatory system in a blatant manner that could easily prompt retaliation by foreign governments against U.S. firms seeking to sell securities abroad. Furthermore, unless this approach were applied to both domestic and foreign issuers, it would not eliminate the competitive advantage that foreign countries with less onerous regulation presently enjoy. But, an administrative system that allowed for ad hoc exceptions for some but not all U.S. issuers would be indefensible.

(3) *Modify U.S. standards for certain categories of issuers irrespective of where they are organized and do business.* The SEC has adopted this approach for addressing some of the problems that are created by international competition for capital markets. It created a series of registration forms for certain foreign issuers which serve as counterparts to Forms S-1-2-3 for U.S. issuers.[91] These special forms, Forms F-1-2-3,[92] relax certain aspects of the disclosure obligations that the 1933 Act and the SEC regulations impose on registrants. The modified disclosure forms can be used by any issuer that qualifies as a "foreign private issuer." An issuer organized outside of the United States is not a foreign private issuer if (1) more than fifty percent of the outstanding voting securities are owned, directly or through voting trust certificates or depositary receipts, by residents of the United States, and (2) if any one of the following apply: (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than fifty percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States.[93] In other words, the F forms can be used by foreign issuers that are truly foreign.

Although this approach does not discriminate by company or by country of organization, as approach (2), *supra*, likely would, it has at least two problems. First, to effectively compete with the regulatory policies of foreign countries, this approach must provide disclosure standards that are significantly less demanding than current U.S. standards. The F Forms offer real advantages to foreign issuers, but the level of mandated disclosure

91. Sec. Act Release No. 6437, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,407 (Nov. 19, 1982).
92. *See* 2 Fed. Sec. L. Rep. (CCH) ¶¶ 6952, 6962, and 6972, respectively.
93. 17 C.F.R. § 240.3b-4(c) (1993).

required by those forms is not much different from the regular S Forms used by domestic issuers. Second, this approach, as implemented by the SEC, leaves domestic issuers with the more onerous disclosure standards thereby creating higher costs of compliance for domestic issuers that register under the Act than those that exist for foreign issuers. Thus, the existing double standard of regulation fails to address the competitive advantage of certain foreign markets with lower regulatory costs, and their ability to attract United States issuers away from domestic markets.

(4) *Adopt disclosure standards on a reciprocal basis with participating countries.* This approach contemplates agreement between the United States and interested foreign countries under which each party to the agreement would accept the regulatory system of the other countries. For example, in a multinational public offering in the United States and country X, the United States would accept the disclosure document as prepared and qualified under the regulations of country X and, for its part, country X would reciprocate by accepting a prospectus meeting the requirements of the 1933 Act. In 1991, the United States and Canada entered into such a reciprocal arrangement under which each country is to accept for certain issuers, which are engaged in cross-border public offerings, the disclosure document prepared and reviewed under the laws and procedures of the home country.[94] Although this multijurisdictional disclosure system has the advantage of simplicity, it does not address the competitive disadvantage that the United States faces with domestic issuers that must accept the heavier regulatory burdens for securities offerings that occur in whole or in part in this country. Furthermore, unless certain minimum disclosure or eligibility standards are included in such reciprocal agreements, U.S. investors might be exposed to serious investment risks.

(5) *Harmonize disclosure standards.* U.S. policymakers under this solution to international regulatory competition would reevaluate domestic disclosure standards and harmonize them and other domestic regulatory principles with those of all major countries. Efforts towards the creation of uniform disclosure standards for multinational securities offerings have already begun under the auspices of IOSCO. If fully implemented, this approach would provide standardization and thus eliminate regulatory competition. But, given the gulf that exists between the regulatory system

---

94. Sec. Act Release No. 6902, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,812 (June 21, 1991).

of the United States and that of countries with developed or developing capital markets, it seems too much to expect that the ideals reflected in international harmonization of securities laws will be realized soon.

For a variety of reasons, some of which are set forth above, none of the five proposals represents a realistic solution to the international regulatory competition that U.S. securities law presently encounters. Furthermore, none of them confronts the related issue of investor protection that distinguishes between sophisticated and unsophisticated participants in the investment markets. The proposal to be described next attempts to address both aspects of the regulatory problem. It is premised, however, on several assumptions.

First, a single solution to all facets of international securities regulatory competition is not possible nor even desirable. Public and private interests in the securities markets can vary significantly among particular areas of regulation. A regulatory decision with respect to one area of securities regulation, such as insider trading, may represent a fair compromise of those interests domestically and serve as a competitive policy or standard internationally. However, it might fail as a solution to conflicts in international regulation in other areas of securities law, such as minimum net capital requirements for broker-dealer firms. Even the general topic of controlling primary offerings that is the focal point of this article is complicated by the close relationship that it has with the issue of regulating secondary trading activity. Viable methods for reducing competitive disadvantages in domestic regulation of issuer-initiated securities offerings and providing adequate protection to vulnerable investors in those offerings may not serve as models for dealing with matters of global competition and investor protection in regulating domestic secondary trading activities by market intermediaries and investors generally.

Second, in order to produce a successful solution to competing principles of securities regulation, even in the narrowest aspect of law, all levels of domestic regulation must be coordinated. A major impediment to U.S. efforts at reconciling its securities laws with those of competing countries is the magnitude and duplication of our regulation. A proposed public offering by an issuer can be subject to regulations, interpretations or policies that are the product of decisions by the SEC, one or more stock exchanges, federal and state judges, the NASD, and administrative agencies in each state where the offering is to occur. If the issuer is a financial institution, one or more federal banking authorities will influence the nature of the transaction. Separate tiers of domestic regulation is probably inevitable and maybe even necessary. For example, state securities laws offer forms of investor protection that federal securities laws are unable to provide effectively or efficiently.[95] The key is to minimize duplication and costs and maximize uniformity in regulatory standards.

Third, total parity in regulation throughout the world never will be possible. Even if harmonization of standards is achieved, as suggested in proposal (5) *supra*, national and local business customs and practices as well as more formal restraints will continue to prevail as points of reference in distinguishing one national market from another. For example, the tradition of private litigation in the United States as a source of preserving one's property rights does not exist in some of the countries, such as Canada and the United Kingdom, where competing securities markets thrive. And yet, it is an important variable in the domestic regulatory system that is likely to survive reforms in our international securities law.

Fourth, any workable solution that fairly integrates and reconciles international principles of securities law cannot be expected to survive without periodic reexamination and reform. Regulatory policies and procedures are crafted for specific activities, problems, and abuses. Changes in government, business, and in economies throughout the world will provide continuous pressures for any regulatory scheme.

Finally, the complexity of investment opportunities is likely to intensify and the number of those opportunities that can be adequately assessed directly by ordinary investors is likely to decrease. The continuing increase in institutional ownership and trading of securities is due in part to the economics of information and the wide-spread acceptance of the portfolio theory. It is also the result of the superior collective knowledge, experience, and bargaining power that institutions possess. In many of the future financial and securities markets, individual investor participation is likely to be *de minimus*.

The proposal that follows is limited by the assumptions set forth above. It speaks only to the issue of primary offerings by issuers and to the level of protection to be accorded ordinary investors in the United States. In short, it seems preferable for U.S. policymakers to reform securities law as it applies to primary offerings by distinguishing among the various markets

95. For a contrary view, see B.J. Fahrney, *State Blue Sky Laws: A Stronger Case for Federal Pre-Emption Due to Increasing Internationalization of Securities Markets*, 86 NEV. V. L. REV. 753 (1992).

for new issues. In those markets where ordinary individual investors are significant participants, or are likely to become significant, regulatory standards should provide those investors with a fair level of protection. On the other hand, for those markets where institutional and other sophisticated investors predominate, and thus require less protection, regulatory standards should be fixed with those participants in mind. In articulating standards and procedures in terms of such stratified markets, domestic policymakers will have greater flexibility to adapt regulatory policies to the competing markets and regulations of foreign countries. Furthermore, because domestic policy will be shaped in reference to particular categories of investors, either institutional or individual, there should be less risk that investor protection, as an important goal of federal securities law, will be overlooked.

Implications of this proposal can be seen by considering how it might affect a registered public offering. Under current securities law, the issuer would file a registration statement with a disclosure statement prepared for the ordinary reasonable investor. Under the proposal, a determination would be made as to whether the proposed offering was likely to interest individual investors. Initial public offerings of equity securities, especially so-called penny stock and blank check offerings, or offerings of interests in mutual funds traditionally have attracted a significant percentage of individual investors.[96] In such instances, more rigorous standards and procedures of the type in existence are appropriate. If, however, the proposed offering involves high-grade debt securities or American Depositary Receipts ("ADRs"),[97] where institutional investors purchase the lion's share of the issue, traditional standards and procedures could be relaxed or eliminated. For example, where offerings were aimed at large, sophisticated investors, the standard of disclosure for registration statements (the ordinary reasonable investor) would refer to an institution. Consequently, the prospectus for such an offering would have a different appearance from the document that

96. For a discussion of the risks that individual investors face in these offerings, see Blank Check Offerings, Sec. Act Release No. 6932, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,937 (Apr. 13, 1992); *Penny Stock Market Fraud: Hearings Before the Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 101st Cong., 1st Sess. (Aug. 21 and Sept. 7, 1989).

97. For a discussion of ADRs, see Sec. Act Release No. 6894, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,740 (May 23, 1991). The SEC estimated that only 15% to 20% of the ADR market is made up of individual investors and that the remainder consists of institutions or brokers. Typically, brokers are engaged in arbitrage. Sec. Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,591 (Mar. 8, 1982).

is prepared in an IPO. In many respects, Rule 415 offerings under existing law reflect this change in format and content for registered issues aimed at institutions.[98] However, by adopting regulations that explicitly distinguish among prospective purchasers, rather than among categories of issuers, which is the method that is used under Rule 415, the SEC could reduce more of the burdens of registration.

Similar reform is possible for issuer offerings of unregistered securities. Certain unregistered offerings by issuers, such as private placements by unseasoned companies and rollups of limited partnerships, are directed at individual investors where tighter regulatory policies are in order.[99] However, other unregistered securities offerings are within the domain of institutional investors. Capital markets of this type include the money market, the bond market, and various markets for so-called derivative instruments such as futures, options, forward contracts, and currency and interest-rate swaps.[100] Where a market is predominantly or exclusively for institutional investors, transactional exemptions should be tailored accordingly. For example, Rule 506 has moved in this direction by eliminating some of the burdens of traditional private placement law (no mandated disclosure and an unlimited number of purchasers) for transactions where the purchasers are institutions. The safe harbor rule that protects issuers from liability for insubstantial and inadvertent failures to satisfy all of the conditions of Regulation D would also assist a Rule 506 issuer. Such protection seems justified where the private placement is predominantly institutional, but it might be unwarranted where the Rule 506 issue is sold principally to nonaccredited individuals. Comparable reforms in some of the other exemptions are possible.

Rule 144A is an exemption from the 1933 Act registration requirements that demonstrates the viability of this proposal for regulation defined by the nature of the investors involved.[101] The Rule provides a nonexclusive safe harbor from the registration requirements of the 1933 Act for resales of

---

98. 17 C.F.R. § 230.415 (1993).

99. *See, e.g.*, Limited Partnership Rollup Reform Act of 1993, Senate Report No. 103-121, 103rd Cong., 1st Sess., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,216 (Aug. 3, 1993).

100. *See* RICHARD W. JENNINGS ET AL., CASES AND MATERIALS ON SECURITIES REGULATION 77 (7th ed. 1992).

101. 17 C.F.R. § 230.144A, adopted in Sec. Act Release No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (Apr. 23, 1990).

certain restricted securities to any "qualified institutional buyer" ("QIBs").[102] Thus, the exemption is available for securities trades in a market occupied exclusively by institutions, i.e., QIBs. In most instances, there are no disclosure obligations.[103] The SEC anticipates that Rule 144A will become "the first step toward achieving a more liquid and efficient resale market for unregistered securities."[104] Although the Rule is unavailable to an issuer of registered securities, it offers many potential benefits to the issuer of unregistered securities. A domestic issuer is permitted to sell its unregistered securities, pursuant to Section 4(2) or Rule 506, for example, to an investment banking firm that immediately resells them into the Rule 144A market. In effect, the investment banker functions as a firm commitment underwriter of securities earmarked for institutional purchasers. Because the QIBs which purchase the restricted securities from the intermediary firm are able to resell immediately to other QIBs in the Rule 144A market, the cost of funds to the issuer is less than it would be in a conventional private placement where purchasers would be saddled with a two year holding period before being able to resell the restricted securities into a public market. The Rule also provides an eligible foreign issuer with easier access to investment funds controlled by large institutions in a private market that U.S. institutional investors might prefer to unfamiliar markets overseas.

III. CONCLUSION

U.S. securities markets are straining from the pressures of global competition for access to capital with a minimum of governmental regulation. All investments carry risk, but in enacting legislation in 1933 and 1934, Congress sought to protect U.S. investors by providing a regulatory scheme that assures full and fair disclosure of material facts in the purchasing, trading, voting and tendering of securities.

---

102. For the definition of a QIB, see 17 C.F.R. § 230.144A(a)(1)(i) (1993). *See also*, 17 C.F.R. § 230.144A(d) (1993) (conditions which must be met for the exemption, including offering the securities to a QIB); 17 C.F.R. § 230.144A(b) and (c) (1993) (the safe harbor provisions).

103. Disclosure obligations arise only where the issuer is not a 1934 Act registrant or a foreign private issuer exempt from the reporting requirements of the 1934 Act through Rule 12g3-2(b). 17 C.F.R. § 230.144A(d)(4) (1993).

104. Sec. Act Release No. 6862, *supra* note 101, at 80,639.

The Securities Act of 1933 was concerned with the protection of investors, primarily unsophisticated individual investors, in large public offerings of securities. It also authorized the SEC to adopt exemptions from the disclosure obligations of public offerings in those transactions where such regulation was unnecessary. In the sixty years since the enactment of this federal statute, the level of protection for ordinary individual investors has declined. In part, this change in protection is explained by changes in the financial and securities markets, both domestic and foreign. The market contemplated by Congress in 1933 was one composed primarily of equity securities where new issues were offered to ordinary individuals. Since that time, individual investors constitute a minority of the owners and traders of equity securities behind insurance companies, mutual and pension funds, and other institutional investors. Furthermore, the number and variety of investment vehicles and specialized markets that are available today call for a regulatory response that is different from the approach that was prompted by the needs of the 1930s. Changes in the form of investment vehicles and in the markets where they trade require a reassessment of how ordinary individual investors in primary offerings should be protected in the context of international business and regulatory competition.

Several solutions to the problem are possible and some have been the subject of SEC experimentation. An optimal approach must proceed on certain assumptions regarding the scope and duration of the proposed solution, the need for a cooperative effort among all levels of federal and state regulators, the likelihood of eliminating all foreign competitive advantages, and the limited role that ordinary investors are likely to play in future securities markets. Subject to these assumptions, the preferred approach for U.S. policymakers seeking to adapt domestic securities regulation to the forces of international business and regulatory competition is to shape standards and procedures to fit the constituents of each carefully defined market. Markets should be defined in terms of the character of the investors that predominate there. More safeguards in standards and procedures are appropriate in markets dominated by unsophisticated individuals. Other markets, including some that might be created by the regulation itself, which are controlled by institutional investors, should be subjected to less rigorous standards and procedures. In theory and in practice, institutional investors can rely upon experience, knowledge, and bargaining power to protect themselves. A bifurcated regulatory system, of the type proposed, should provide U.S. policymakers more flexibility to restructure domestic capital markets and domestic regulatory policies to compete in a global economy that continues to develop.