

Commentary: Shift in Regulation Towards Sophisticated Investors

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Last April, I wrote about the disclosure proposal for asset-backed securities that was released recently by the SEC. Among many other things, the proposal would require extensive disclosure to accredited investors who purchase asset-backed securities in private placements. Under current rules, no disclosure is required to be made to accredited investors in private placements of any kind.

The notion that sophisticated investors, and particularly institutional investors, require the disclosure and other investor protections of the securities laws would be a dramatic change in regulatory philosophy. I think it is safe to say that there are no securities lawyers now living who have not been taught as a “first principle” the mantra that the disclosure requirements for securities offerings are intended to protect unsophisticated, retail investors, rather than sophisticated institutional investors. As a result, I wondered, as did many securities lawyers, whether this conceptual change by the SEC would be limited to asset-backed securities, which were blamed by many for the recent financial crisis and continuing economic woes, or whether it represented a reconsideration of a fundamental principle of securities regulation.

A recent speech by SEC Commissioner Luis Aguilar indicates that the change in regulatory philosophy is not limited to asset-backed securities.

The Securities Act of 1933 is the cornerstone on which the U.S. regulation of securities is based. Its famous Section 5 prohibits the sale of securities to any person who has not been provided with a prospectus, previously filed with the SEC, that makes certain required disclosures about the issuer and the securities. Sections 3 and 4 then carve out exemptions to this extremely broad rule. Section 4(2) exempts any sale of securities by an issuer “not involving a public offering.” This exemption is commonly described as the “private placements exemption.”

However, nothing in the Securities Act requires that an offering made solely to accredited investors be treated as a sale “not involving a public offering.” Section 4(5) provides a specific exemption for private offers and sales by issuers to accredited investors, but only where the amount of the offering is limited to \$5 million. The idea that sales of larger amounts of securities to accredited investors can be considered as “not involving a public offering” is a creature of SEC

regulation, and actually represents quite a liberal view of the SEC's authority under Section 4(2).

Relying on Section 4(2), the SEC many years ago promulgated Regulation D, and in particular Rule 506, which is the Rule that permits issuers to sell an unlimited amount of securities to sophisticated investors in private placements without any disclosure. Rule 506 vastly expanded the private placement exemption beyond the apparent limitations of Congressional intent expressed in Section 4(5). Some thought that Rule 506 was too permissive. For many years after Rule 506 became part of federal securities law, State securities laws required that sales of securities issued in private placements to accredited investors be "qualified," which meant that issuers were required to prepare and file offering documents that made certain disclosures to accredited investors, despite the federal exemption from disclosure requirements. That all changed when Congress enacted the National Securities Markets Improvements Act in 1996. Since then, the States have been prohibited from requiring any disclosure in private placements made solely to accredited investors.

This deregulatory trend is now up for grabs.

On October 15, while speaking at the University of California at Berkeley, Commissioner Aguilar pointed to recent cases involving auction rate securities and pension funds as proof that sophisticated institutional investors need the transparency, disclosure, and other protections of federal securities laws. He also argued that retail investors in vehicles managed by institutional investors are hurt when these sophisticated investors misjudge investment risks. Commissioner Aguilar invoked the financial crisis as an example of how the larger public, and the national economy, also are adversely affected by the failure to provide disclosure to sophisticated institutional investors.

Commissioner Aguilar's argument turns current regulatory philosophy on its head. Even if you think the goal of the federal securities laws should be to protect unsophisticated retail investors, Aguilar contends that this goal cannot be satisfied unless the disclosure requirements of federal securities laws also are applied to investments by sophisticated institutional investors, at least if those investments are large enough to have an impact on the larger economy, creating what is called "systemic risk." Under this new theory, private placements would be exempt, not because they are sold to sophisticated investors, but because they are limited in size and therefore unlikely to have much effect on anyone other than their participants. Large private placements, perhaps all of those greater than the \$5 million limitation specifically provided by Congress in Securities Act Section 4(5), would not be exempt because of their impact on retail investors and the national economy.

Of course, Commissioner Aguilar is one of five SEC Commissioners, and his name was put forward by the Democrats. My guess is that we will not hear similar heresy from Republican Commissioners, like Kathleen Casey. But Commissioner Aguilar's remarks suggest that the proposed asset-backed securities rules are not an anomaly. Serious minds at the SEC are rethinking the way investments by institutional investors are regulated.

It is hard to overemphasize the extent to which this new regulatory philosophy would change the way things are done. An entire industry has grown up around selling securities in private placements. The growth of the hedge fund industry in many ways can be attributed to the rise of private placements. Investments in hedge funds are privately placed, and when created, hedge funds become accredited investors with huge appetites for privately placed securities. Any size limitation on private placements would mean fewer and smaller hedge funds. In turn, the appetite for investments in privately placed securities would decline precipitously.

The fact is that it is a lot cheaper to do a private placement than a public offering. As a result, the rise of private placements put an end to small public offerings and the willingness of investment banks to engage in them. Small issuers are not eager to undertake the expense of a public offering, and the costs imposed by additional regulatory scrutiny, if they are able to raise capital much more cheaply in private placements.

Reversing the trend by limiting private placements implies that a larger number of securities issues would be handled as public offerings and many more securities issues (and issuers) would be subject to regulatory oversight. On the one hand, securities offerings would be more expensive for issuers and less profitable for investment banks. Economic theory suggests that means fewer offerings. On the other hand, there would be also be less fraud.

The trade-off would be worth it if another financial crisis could be averted. But, how will we ever know for sure?