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## Regulation of Rule 506 Private Placements: The Teetering Balance Between Investor Protection and Capital Formation

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## COMMENT

# REGULATION OF RULE 506 PRIVATE PLACEMENTS: THE TEETERING BALANCE BETWEEN INVESTOR PROTECTION AND CAPITAL FORMATION

*ILON OLIVEIRA\**

“An investment in knowledge pays the best interest.”  
–Benjamin Franklin

### INTRODUCTION

Currently, a modern day gold rush is booming in the Silicon Valley. Increasing numbers of individuals are flooding the streets of the San Francisco Bay Area with their dream to start the next breakout company—the next “Facebook” or “Uber.” There are television shows based on this trend, and the United States government has even shown its support by issuing new regulations that allow issuers to advertise private investments to the general public. As a result, the idea of the “average Joe” investing in private companies has spread like wildfire throughout the nation and has facilitated the hype surrounding Silicon Valley and the huge amount of money flowing in the streets of the San Francisco Bay

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Area. But what happens with private investing outside of the Silicon Valley, where the hype disappears and the video cameras stop rolling?

Imagine this: Sally is a 35-year-old single mother who lives and works fulltime in Billings, Montana, and is very active in her church. Last July, Sally was approached by a fellow church member about an investment opportunity that he said was too good to miss. The man represented himself in the church as a very successful money manager for ABC Enterprises, Inc., a firm comprising “extremely knowledgeable strategists with years of experience working with top financial firms on Wall Street.” Sally wasn’t sure what a money manager was, but after being told that ABC practiced safe and careful investing in private investment products, that the investments were risk-free, and that ABC guaranteed that investors would earn between 4% and 20% per quarter, she believed that it was safe and he must have been trustworthy. Sally initially invested \$5,000. Each quarter she received statements that showed high returns. Based on this and pressure from the money manager, Sally withdraws all of her savings and invests it with ABC. Soon, however, Sally learns that she has lost her entire life savings. She is a victim of fraud and will later learn that there is virtually no way for her to get her lost savings back.<sup>1</sup> Sally’s situation is just one of many that currently occur in the private placement market, in which the uninformed, elderly, and misinformed have been taken advantage of and lost everything—with little to no recourse.

Since the creation of Regulation D in 1982, Congress and the Securities and Exchange Commission (SEC) have attempted to balance the growth of small businesses<sup>2</sup> while maintaining adequate safeguards for investor protection.<sup>3</sup> In the most recent in a series of amendments aimed at maintaining investor protection<sup>4</sup> and facilitating capital formation,<sup>5</sup> Congress has mandated amendments to Regulation D (“Reg. D”) private placement offerings by adopting the Dodd-Frank Wall Street Reform and

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<sup>1</sup> This hypothetical situation is based on one provided by the Securities and Exchange Commission. See *Too Good To Miss*, U.S. SEC. & EXCHANGE COMMISSION, <http://investor.gov/node/154> (last visited May 25, 2015).

<sup>2</sup> See, e.g., Access to Capital for Job Creators Act, H.R. 2940, 112th Cong. (2011) (providing for removal of regulatory ban that prevents small, privately held companies from using advertisements to solicit investors). This bill was eventually incorporated into the 2012 JOBS Act. See Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012).

<sup>3</sup> Jennifer J. Johnson, *Fleeing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993, 994 (2012).

<sup>4</sup> Bruce Dravis, *Public Advertising of Private Investment Offerings: The Operation and Issues in Post-Jobs Act Regulation D*, 13 U.C. DAVIS BUS. L.J. 295, 296 (2013).

<sup>5</sup> *Id.* at 297.

Consumer Protection<sup>6</sup> (“Dodd-Frank”) and Jumpstart Our Business Startups<sup>7</sup> (JOBS) Acts. These amendments, as promulgated by the SEC, have revived the decades-long debate about the safety of investors, potential for fraud in the private placement market, and the adequacy of protection for investors.<sup>8</sup> As a result of the laws and amendments affecting Reg. D private placement governance, dangers of fraud in the offer and subsequent resale of private placements have significantly increased, and adequate safeguards for investors have not been maintained.<sup>9</sup>

This Comment aims to show that since the creation of Reg. D private placements, Congress and the SEC have promulgated a series of amendments and enactments that have collectively resulted in a heightened risk of fraud and inadequate safeguards for investors. Part I of this Comment will discuss private placements and the significant enactments and amendments that affect Rule 506 private placement offerings (“Rule 506 offerings”). The most notable amendments in this discussion will include the preemption of state blue-sky laws in 1996, the shortening of the holding period before resale in 2007, the exclusion of an investor’s primary residence in the calculation of net worth for accredited investor status in the 2010 Dodd-Frank Act, and, as part of the 2012 JOBS Act, the permission for general solicitation and advertising of private placement issues, and the increase in the shareholder threshold for forced registration.

Part II of this Comment will point out the laws affecting Rule 506 private placement offerings that collectively result in failures to protect investors from fraud. Specifically, it will address the lax reporting requirements currently in place, the outdated classification of investors permitted to invest in Rule 506 offerings,<sup>10</sup> and the dangers presented with the permission of “general solicitation” in Rule 506 offerings. Part II will also address the dangers with the shortened resale period and increase in shareholder threshold for forced registration, and it will discuss the fraudulent practices that occur in the offering, resale, and subsequent

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<sup>6</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C.A. § 5301 et seq. (Westlaw 2015).

<sup>7</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012).

<sup>8</sup> “[A]ny regulation that purports in any way to impede capital formation by small business invariably comes under attack as ‘over regulation’ . . . as the diatribes from Washington, D.C. today make all too clear.” Johnson, *supra* note 3, at 996.

<sup>9</sup> Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Public Statement: Facilitating General Solicitation at the Expense of Investors (July 10, 2013), *available at* [www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370543419272](http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370543419272).

<sup>10</sup> Under the current Regulation D rules, Rule 506 offerings are primarily offered to investors that qualify for accredited investor status as defined in Rule 501. 17 C.F.R. § 230.501(a) (Westlaw 2015).

trading of private placements in the secondary markets, primarily due to the inadequate regulations currently in place. Part III of this Comment will provide suggested amendments to the existing regulations in order to provide a clearer and more comprehensive guideline for Rule 506 offerings. Finally, the Conclusion of this Comment assembles the issues, arguments, and solutions set forth.

#### I. PRIVATE PLACEMENTS GENERALLY

Private placements “take place when a company sells an investment outside of the normal public securities market.”<sup>11</sup> The private placement market consists of several different markets,<sup>12</sup> each made up of small or large companies taking advantage of the various exemptions to the registration requirement set forth in the Securities Act of 1933 (“Securities Act”) in an attempt to raise funds from different types of investors.<sup>13</sup> This Comment is concerned with Rule 506 offerings, which occur outside of the normal registration process and initial public offering of securities process and are facilitated by financial intermediaries and other issuers that offer these private placements to “accredited” investors whom they have solicited.<sup>14</sup> Accredited investors are those individuals in the general public who meet certain minimum requirements as set forth in the Securities Act.<sup>15</sup> When financial intermediaries, such as stockbrokers with broker-dealers or finders, offer private placements, the solicited accredited investors must also meet minimum suitability requirements set forth by the Financial Industry Regulatory Authority (FINRA).<sup>16</sup> When an investor purchases securities through a private offering exempt under Reg. D, he or she will receive restricted securities that must be held for a time period as set out in Rule 144 of the Securities Act before he or she can resell the securities.<sup>17</sup> Once this holding period

<sup>11</sup> Johnson, *supra* note 3, at 995.

<sup>12</sup> *Id.* at 997.

<sup>13</sup> *Id.* at 997–98.

<sup>14</sup> *Id.* at 998.

<sup>15</sup> 17 C.F.R. § 230.501(a) (Westlaw 2015).

<sup>16</sup> According to FINRA Rules for the obligations of Broker-Dealers (“BD”) in Regulation D offerings, the BD must have reasonable basis to believe that the recommendation of a particular transaction is suitable for the investor based on a reasonable assessment of the investor’s investment profile, which includes information such as the investor’s knowledge and experience. FINRA Rule 2111, Suitability, available at [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=9859](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9859) (last visited May 27, 2015). A foreseeable and implied consequence of a BD’s responsibility to recommend transactions suitable for an investor, the BD must also ensure that the investor qualifies as an accredited investor for a Rule 506 transaction.

<sup>17</sup> Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Public Statement: Increasing the Vulnerability of Investors (Aug. 29, 2012), available at [www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491128](http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491128).

has expired, if the investor obtains a legal opinion suggesting that the foregoing is true and that any restrictive “legends” on the securities be removed, and if the transfer agent concurs with the legal opinion and removes the “legends,” the investor may resell the securities to anyone.<sup>18</sup>

As the many highly publicized startups with multi-billion dollar valuations have exhibited,<sup>19</sup> Rule 506 private placement offerings have allowed many companies, small and large alike, to raise funds and flourish as a result.<sup>20</sup> The vast majority of Rule 506 offerings represent fundraising efforts by legitimate business entities; however, as will be discussed later in this Comment, they are extremely risky, and some have resulted in significant fraud.<sup>21</sup>

#### A. THE HISTORY OF PRIVATE PLACEMENT GOVERNANCE

##### 1. *Securities Act of 1933*

As a result of the economic crisis of the Great Depression, Congress passed the first federal securities laws in the Securities Act of 1933.<sup>22</sup> The goals of these laws were to facilitate full disclosure and transparency when a company engages in a securities transaction with the public.<sup>23</sup> The Securities Act governs the requirements for the registration of securities to be issued by companies and also provides for exemptions to this registration requirement.<sup>24</sup> Section 12(g)(1) of the Securities Act sets forth the threshold requirements for when a company must register its securities and engage in a public offering.<sup>25</sup> Under section 5 of the Securities Act, transactions conducted in securities that have not been registered or do not qualify for an exemption from registration are

<sup>18</sup> *Id.*

<sup>19</sup> See, e.g., Scott Austin, Chris Canipe & Sarah Slobin, *The Billion Dollar Startup Club*, WALL ST. J., Feb. 18, 2015, <http://graphics.wsj.com/billion-dollar-club/>.

<sup>20</sup> Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Address at the North American Securities Administrators Association, Annual NASAA/SEC 19(d) Conference, Washington, D.C.: Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts To Weaken Investor Protections (Apr. 16, 2013), available at [www.sec.gov/News/Speech/Detail/Speech/1365171515400](http://www.sec.gov/News/Speech/Detail/Speech/1365171515400).

<sup>21</sup> See *id.* (“[T]he Rule 506 exemption has resulted in significant fraudulent activities. Reports from state and federal securities regulators have shown that Rule 506 offerings are frequently the subject of enforcement investigations and actions. In fact, just in 2011, state regulators and the SEC, collectively, filed more than 324 enforcement actions related specifically to Rule 506 offerings.” (footnote omitted)).

<sup>22</sup> Johnson, *supra* note 3, at 994.

<sup>23</sup> *Id.* at 994.

<sup>24</sup> 17 C.F.R. pt. 230 (Westlaw 2015).

<sup>25</sup> 17 C.F.R. § 240.12g-1 (Westlaw 2015).

prohibited,<sup>26</sup> and section 4 sets out a list of securities that are exempt from registration for transactions “not involving any public offering.”<sup>27</sup>

## 2. *Securities Exchange Act of 1934*

In 1934, Congress passed the Securities Exchange Act of 1934 (“Exchange Act”).<sup>28</sup> While the Securities Act of 1933 focused on transparency and registration requirements,<sup>29</sup> the Exchange Act of 1934 was an effort to regulate securities transactions on the securities exchanges and in the secondary markets.<sup>30</sup> Within this Act, Congress set forth anti-fraud rules and established the SEC as the governing agency for the securities industry.<sup>31</sup> While there are several anti-fraud provisions within the Exchange Act, 17 C.F.R. § 240.10b-5 (“Rule 10b-5”) has become the catchall standard for securities fraud liability.<sup>32</sup> As support of the use of Rule 10b-5 as a catchall standard, a series of Supreme Court cases have restricted the ability of a victim of fraud to impose liability in a private action.<sup>33</sup> Thus, when regulators and defrauded investors seek retribution for a securities violation in the private market, they generally rely only on Rule 10b-5 to enforce liability for fraud.<sup>34</sup> However, even in the best of securities fraud cases, the likelihood that a defrauded investor will actually recover his or her lost funds is highly unlikely, as a fraudulent issuer is likely to have spent or lost the funds prior to the enforcement action.

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<sup>26</sup> 15 U.S.C.A. § 77e (Westlaw 2015).

<sup>27</sup> 15 U.S.C.A. § 77d (Westlaw 2015).

<sup>28</sup> 17 C.F.R. pt. 240 (Westlaw 2015).

<sup>29</sup> Johnson, *supra* note 3, at 994.

<sup>30</sup> 17 C.F.R. pt. 240 (Westlaw 2015).

<sup>31</sup> *Id.*

<sup>32</sup> 17 C.F.R. § 240.10b-5 (Westlaw 2015)

(“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”).

<sup>33</sup> “Unfortunately, a series of Supreme Court cases has restricted aiding and abetting liability in private actions. I agree. . .that Congress amend the Securities Exchange Act of 1934 (‘Exchange Act’) to allow for a private civil action against a person that provides substantial assistance in violation of the Exchange Act.” Aguilar, *supra* note 20.

<sup>34</sup> Andrew Stephenson & Sarah Hanks, *An Overlooked Class of Private Offerings: Independent Rule 506(c) Raises*, 45 Sec. Reg. & L. Rep. (BNA) 1901, 1094-08 (Oct. 14, 2013).

### 3. 1972 Adoption of Rule 144 Safe Harbor

In 1972, Congress enacted and the SEC adopted Rule 144, which established a resale safe harbor for restricted securities and clarified securities resale restrictions.<sup>35</sup> Rule 144 was adopted with the goal of providing investors in private placements a way to sell their shares and as a way for companies to raise additional funds by permitting the trading of private placements securities in the secondary markets.<sup>36</sup> Under Rule 144, restricted securities may be resold after a specific holding period, provided that certain information and transaction requirements are met.<sup>37</sup>

### 4. 1982 Adoption of the Regulation D Exemption

In 1982, the SEC adopted Regulation D as a way to provide companies issuing private placements with rules for conducting a securities offering while avoiding the cost and effort of filing a registration statement with the SEC.<sup>38</sup> Within Regulation D, the SEC introduced three categories of rules. The first category of rules, Rules 501, 502, and Rule 503, provides the definitions and conditions that issuers must abide by in order to conduct private placement offerings under Reg. D. This includes investor classification requirements<sup>39</sup> and information disclosure requirements.<sup>40</sup> Reg. D's second category, Rules 504, 505, and 506, provides the exemptions that may be claimed by a private placement issuer in conducting an offering.<sup>41</sup> This Comment is particularly concerned with the Rule 506 exemption, as it is the most widely used in Reg. D offerings,<sup>42</sup> and the regulations imposed on the offer and resale of securities

<sup>35</sup> 17 C.F.R. § 230.144 (Westlaw 2015); see also C. Steven Bradford, *Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions*, 49 EMORY L.J. 437, 440 (2000).

<sup>36</sup> Bradford, *supra* note 35.

<sup>37</sup> Rule 144 requires that information about the issuer of the restricted securities be made publicly available, that the number of securities to be sold be limited, that the securities be sold in "brokers' transactions," and, depending on the offering, that a notice of sale be filed with the SEC. 17 C.F.R. § 230.144 (Westlaw 2015); see also Bradford, *supra* note 35, at 458–59.

<sup>38</sup> Dravis, *supra* note 4, at 301.

<sup>39</sup> Rule 501(a) defines "accredited investor" as any person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1,000,000, or any natural person who had an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year. 17 C.F.R. § 230.501(a)(6) (Westlaw 2015).

<sup>40</sup> Rule 503 sets forth the requirement of the filing of a Form D to provide the SEC with a notice of sales for each new offering conducted by the issuer. 17 C.F.R. § 230.503 (Westlaw 2015).

<sup>41</sup> 17 C.F.R. §§ 230.504–.506 (Westlaw 2015).

<sup>42</sup> Rule 506 provides issuers with an exemption to the registration requirement without regard to the dollar amount of the offering, provided the issuer complies with the terms and conditions of §§ 230.501 and 230.502 and the issuer believes that there are no more than 35 unaccredited investors



claimed under the exemption.<sup>43</sup> The third category of rules, Rule 507 and Rule 508, sets forth the consequences of noncompliance with the requirements of Reg. D.<sup>44</sup>

B. SIGNIFICANT ENACTMENTS AND AMENDMENTS AFFECTING PRIVATE PLACEMENT OFFERINGS

1. *National Securities Markets Improvement Act of 1996*

In an effort to ease the process of offering private placements in the national securities markets and to promote capital formation for small businesses, Congress enacted the National Securities Markets Improvement Act of 1996 (NSMIA).<sup>45</sup> NSMIA, among other things, amended Section 18 of the Securities Act of 1933 and preempted the state blue-sky registration requirements for private placements, including Rule 506 exempted offerings.<sup>46</sup> Prior to NSMIA, a private placement had to fall within an exemption of the blue-sky laws of each state in which investors were solicited in order to avoid state registration.<sup>47</sup> Because of this, companies issuing private placements were faced with the burden of complying with the varying regulations of each state as well as federal regulations.<sup>48</sup> Now, issuers of private placements claiming the Rule 506 exemption need only comply with federal registration and exemption requirements when soliciting investors nationally.<sup>49</sup>

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in the offering. 17 C.F.R. § 230.506 (Westlaw 2015). Rule 506 has accounted for 99% of the amounts raised by the Reg. D exemption from 2009–2012, and it has accounted for 94% of new offerings during that period. VLADIMIR IVANOV & SCOTT BAUGUESS, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, at 5 (July 2013), available at [www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf](http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf).

<sup>43</sup> Under Rule 506, offers and sales of securities by an issuer under this exemption are deemed to be transactions not involving any public offering as set forth within Section 4(a)(2) of the Securities Act. In utilizing this exemption, issuers are permitted to raise an unlimited amount of funds from an unlimited amount of accredited investors or from no more than thirty-five unaccredited investors, so long as there was no general solicitation and the other conditions set forth in Regulation D are satisfied and the appropriate resale limitations are applied. 17 C.F.R. § 230.506 (Westlaw 2015).

<sup>44</sup> 17 C.F.R. §§ 230.507-08 (Westlaw 2015).

<sup>45</sup> 15 U.S.C.A. § 77r (Westlaw 2015); see also William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143, 1152 (2013).

<sup>46</sup> Sjostrom, Jr., *supra* note 45.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* The state blue-sky-law preemption is a feature unique to Rule 506 Reg. D offerings and has been suggested to be highly attractive to private placement issuers. See IVANOV & BAUGUESS, *supra* note 42, at 7.

2. *2007 Amendment of Rule 144 Resale Safe Harbor*

Since the SEC adopted the Rule 144 resale safe harbor, which allows for the resale of restricted securities after a specific holding period and certain conditions are met,<sup>50</sup> over the years, Rule 144 has been gradually liberalized by the addition of various amendments.<sup>51</sup> Most recently, in 2007 the SEC amended Rule 144 in order to reduce the required holding periods of restricted securities; the time required to hold the restricted securities is based solely on whether the issuer is a public or private company.<sup>52</sup> Under the current rule, as amended, if the securities are issued by a private company, the holding period is one year, and if the securities are issued by a public company, the holding period is six months.<sup>53</sup> Therefore, once a private company has issued shares pursuant to a Rule 506 private placement offering, the securities may be resold in the secondary market after only one year.

3. *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*

In 2010, Congress enacted the Dodd-Frank Act in an effort to protect investors from abusive practices in the financial services industry.<sup>54</sup> The most significant part of the act, with respect to this Comment and Rule 506 offerings, addresses the calculation of net worth under the accredited investor standard.<sup>55</sup> The Dodd-Frank Act provides that the value

<sup>50</sup> 17 C.F.R. § 230.144 (Westlaw 2015). If an investor wants to sell his or her restricted securities pursuant to the Rule 144 safe harbor, the securities must meet the rule's five conditions:

- 1) Before an investor may sell restricted securities, they must be held for a certain period of time. If the company that issued the securities is a reporting company subject to the reporting requirements of the Exchange Act, the holding period is six months. If the company is a privately held company that is exempt from registration requirements, the holding period is 1 year.
- 2) There must be current information about the issuing company publicly available; for non-reporting companies that issue private placements, information regarding the nature of the company business and the officers must be made available.
- 3) The trading volume of the stock must be within a minimal percentage of the outstanding shares.
- 4) The sales must be handled as ordinary brokers' transactions.
- 5) A Form 144 must be filed with the SEC if the investor is an affiliate and the sale involves a significant amount of shares or money.

*See Rule 144: Selling Restricted and Control Securities*, SECURITIES AND EXCHANGE COMMISSION, [www.sec.gov/investor/pubs/rule144.htm](http://www.sec.gov/investor/pubs/rule144.htm) (last visited May 26, 2015).

<sup>51</sup> *See* Bradford, *supra* note 35, at 458.

<sup>52</sup> 17 C.F.R. § 230.144 (Westlaw 2015); *see also* Sjostrom, *supra* note 45, at 1150–51.

<sup>53</sup> *Id.*

<sup>54</sup> 12 U.S.C.A. § 5301 et seq.; *see also* Aguilar, *supra* note 20.

<sup>55</sup> *Id.*

of an individual retail investor's home is excluded when calculating net worth for accredited investor status qualification.<sup>56</sup> In excluding the value of a residence from an investor's net worth, the basis of net worth is primarily based on income and other assets.<sup>57</sup> Thus, individuals with less investment experience who have been frequently targeted for investment fraud will find it more difficult to qualify as accredited investors and participate in risky private placement investments.<sup>58</sup>

#### 4. *Jumpstart Our Business Startups Act of 2012*

Shortly after Dodd-Frank, Congress passed the JOBS Act in an effort to enhance the ability of small businesses to raise capital by permitting them to reach a broader range of investors.<sup>59</sup> With respect to Rule 506 offerings, the provisions and amendments set forth in Title II and Title V of the JOBS Act are the most significant. In Title II of the JOBS Act, Congress directed the SEC to eliminate the prohibition on general solicitation and advertising for Rule 506 offerings, provided the investors are accredited investors and the corporations have taken reasonable steps to verify their accredited investor status.<sup>60</sup> Within Title V, Congress amended Section 12(g)(1) of the Securities Act<sup>61</sup> and increased the threshold for forced registration.<sup>62</sup> Now, a private company must register with the SEC and conduct an initial public offering when it has met the threshold amount of 2,000 shareholders, provided 1,500 of those shareholders are accredited.<sup>63</sup> As a result of the amendments set forth in the JOBS Act, Congress provided small businesses with a wider span of access to investors as well as the ability to remain private longer, resulting in more capital being raised in the private placement market.<sup>64</sup>

<sup>56</sup> Section 413(a) of The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the definition of an "accredited investor" in 17 C.F.R. § 230.501 to exclude from the calculation of an individual or couple's net worth the value of a primary residence. 12 U.S.C.A. § 5301 et seq., (Westlaw 2015) full text of the Act available at <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf> (last visited June 14, 2015).

<sup>57</sup> See Johnson, *supra* note 3, at 1002.

<sup>58</sup> "Under current SEC regulations, wealth (at least measured by 1982 standards) is a complete substitute for financial sophistication and required disclosure. . . . One might hope that removing the house from the \$1 million calculation will help protect [individuals]." *Id.*

<sup>59</sup> Stephenson & Hanks, *supra* note 34.

<sup>60</sup> SEC. & EXCH. COMM'N, ELIMINATING THE PROHIBITION AGAINST GENERAL SOLICITATION AND GENERAL ADVERTISING IN RULE 506 AND RULE 144A OFFERINGS, 17 C.F.R. §§ 230 & 239, at 14, available at [www.sec.gov/rules/final/2013/33-9415.pdf](http://www.sec.gov/rules/final/2013/33-9415.pdf) (last visited May 27, 2015).

<sup>61</sup> 17 C.F.R. § 240.12g-1 (Westlaw 2015).

<sup>62</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313-14 (2012).

<sup>63</sup> The amendment also excluded from this count those shareholders that are employees that received their shares as part of their compensation. Sjostrom, *supra* note 45, at 1153.

<sup>64</sup> *Id.*

5. *SEC Promulgation of JOBS Act Rule 506 Amendment*

In implementing the directive set forth in the JOBS Act, the SEC amended Rule 506 and split it into two classifications: Rule 506(b) and Rule 506(c) offerings.<sup>65</sup> Rule 506(b) offerings were maintained as the classic Rule 506 offerings, in which issuers do not engage in general solicitation and advertising.<sup>66</sup> Offerings conducted under Rule 506(c) follow the same general standards as classic Rule 506 offerings; however, an issuer is permitted to engage in the use of general solicitation and advertising,<sup>67</sup> so long as investors are accredited, the issuer has taken reasonable steps to verify<sup>68</sup> that the investors are actually accredited, and the issuer has a reasonable belief that the investor is accredited.<sup>69</sup> Along with these additional requirements, the SEC also amended Form D to include a check box for those claiming the Rule 506(c) exemption.<sup>70</sup> An issuer is now required to file Form D at least fifteen days prior to the use of general solicitation or advertising and within thirty days after the conclusion of the offering.<sup>71</sup> The SEC created these rules as further clarification of the mandated amendment set forth in the JOBS Act and as an attempt to mitigate harm to investors.<sup>72</sup>

<sup>65</sup> SEC. & EXCH. COMM'N, *supra* note 60, at 12.

<sup>66</sup> *Id.*

<sup>67</sup> 17 C.F.R. § 230.506 (Westlaw 2015). Under the rule, general solicitation generally includes anything publically available in print, broadcasted, and posted on the Internet that provides information about a securities offering. *See* Stephenson & Hanks, *supra* note 34.

<sup>68</sup> Under the “reasonable steps” requirement, the SEC established an objective approach in which issuers are expected to take various factors into consideration, including 1) the nature of the purchaser and type of accredited investor that the purchaser claims to be, 2) the amount and type of information that the issuer has about the purchaser, and 3) the nature of the offering, which includes the manner in which the purchaser was solicited and the terms of the offering. SEC. & EXCH. COMM'N, *supra* note 60, at 14.

<sup>69</sup> *Id.* at 11–12.

<sup>70</sup> *Id.* at 1.

<sup>71</sup> *Id.*

<sup>72</sup> “Currently, an SEC rule provides guidance on when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of the federal securities laws. Under the proposal, this guidance. . . would be extended to the sales literature of private funds. It would apply to all private funds whether or not they are engaged in general solicitation activities.” U.S. Sec. & Exch. Comm’n, Fact Sheet, Proposing Amendments to Private Offering Rules, SEC Open Meeting (July 10, 2013), *available at* [www.sec.gov/news/press/2013/2013-124-item3.htm](http://www.sec.gov/news/press/2013/2013-124-item3.htm).

II. FLAWS AND FRAUD IN THE RULE 506 PRIVATE PLACEMENT MARKET

A. ISSUES WITH THE CURRENT REGULATION OF RULE 506 OFFERINGS

Due to the increasing activity in the startup community and the necessity of capital to facilitate this, the amount of offerings being conducted in the private placement market, primarily with the use of the Rule 506 exemption, continues to increase each year.<sup>73</sup> In 2012, \$1.7 trillion was raised through all private investment channels, with \$903 billion being reported as raised through Reg. D offerings that year.<sup>74</sup> The importance of the Reg. D market, as well as its adequate regulation, is further magnified by the fact that there were over 49,000 new unique issuers of Reg. D offerings from the year 2009 to 2012, with more than 234,000 investors participating and over \$91 billion raised in 2012 alone.<sup>75</sup> Although the aforementioned amendments have been beneficial in some regards, in that they have made it easier for legitimate companies to engage in Rule 506 offerings and raise funds, they have also resulted in heightened opportunity for fraud and weakened investor protection.

This Section discusses how these collective laws and amendments have resulted in minimal reporting requirements, an outdated accredited investor qualification for those permitted to invest in Rule 506 offerings, dangers associated with the allowance of general solicitation in Rule 506 offerings, the dangers in the shortened resale period and increase in shareholder threshold for forced registration, and increased fraudulent practices occurring in the offering and trading of private placements in the secondary Over the Counter (OTC) markets.

1. *Minimal Reporting Requirements*

Currently under the Reg. D rules, an issuer is directed to file a Form D with the SEC fifteen days prior to conducting a classic Rule 506 offering. However, the filing of this form is not a condition to claiming the exemption for the offering, so for practical purposes, it is essentially a voluntary courtesy to the SEC.<sup>76</sup> Also, other than the minimal amount of

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<sup>73</sup> From 2009 to 2012, the number of Reg. D offerings increased from 20,841 to 31,471, with Rule 506 accounting for 99% of the amounts sold through Reg. D during that period. IVANOV & BAUGUESS, *supra* note 42, at 9.

<sup>74</sup> *Id.* at 3.

<sup>75</sup> *Id.* at 5.

<sup>76</sup> Aguilar, *supra* note 17.

information required on Form D,<sup>77</sup> there is no information statement or disclosure required to be filed with the SEC, and “[w]hile private placement sellers must file a Form D with the SEC, the required information is minimal, and the SEC staff rarely reviews or even looks at these forms.”<sup>78</sup> With a Rule 506 offering, no information statement is required at all, provided all of the investors are accredited investors.<sup>79</sup> When an issuer is soliciting investors who do not qualify as accredited investors, certain information requirements apply, but they are also minimal in nature. In order to satisfy the information requirements and aid investors in making informed investment decisions, an issuer will generally provide investors with a private placement memorandum (PPM). PPMs contain the same types of information and disclosures found in a prospectus; however, PPMs are not required to be filed with the SEC<sup>80</sup> and regulators have little to no access to disclosures made by the issuer in a private placement offering.<sup>81</sup> Because PPMs are not filed with the SEC, it is easier for issuers to provide misleading information to potential investors regarding the amount of the offering, potential returns on investment, and what the funds are ultimately being used for.<sup>82</sup>

With the minimal reporting requirements that are currently in place, issuers of Rule 506 private placement offerings are able to raise an unlimited amount of funds while providing a very minimal amount of information to the SEC. SEC Commissioner Luis A. Aguilar, along with other commenters, has urged the SEC to require Form D as a condition to claiming a Rule 506 exemption, and further, to modestly expand the information required to be provided on the form.<sup>83</sup> Thus, investors who are familiar with Rule 506 offerings recognize that the lack of information retained by the SEC to regulate these types of exempted offerings has heightened the risk of fraud to unsuspecting investors.

<sup>77</sup> Form D requires very minimal information, including the financial size of the issuer, the number of and sophistication of potential investors, names and traceable information of the controlling persons of the corporation and any associated persons, and some minimal documentation confirming the existence of the functioning operation for which the funds are being raised. See U.S. SEC. & EXCH. COMM’N, FORM D, available at [www.sec.gov/about/forms/formd.pdf](http://www.sec.gov/about/forms/formd.pdf).

<sup>78</sup> Johnson, *supra* note 3, at 1003–04.

<sup>79</sup> Aguilar, *supra* note 17 (“The SEC has long operated under the principal that accredited investors do not need the same types of protections as the general public. They are assumed to have the sophistication to understand the terms of a securities offering and the ability to sustain a complete loss of the investment.”); Stephenson & Hanks, *supra* note 34.

<sup>80</sup> Sjostrom, *supra* note 45, at 1147.

<sup>81</sup> Johnson, *supra* note 3, at 995.

<sup>82</sup> Under Rule 506, no information statement or other disclosure is required to be provided if all the purchasers are accredited investors. 17 C.F.R. § 230.506 (Westlaw 2015). “Form D currently does request information regarding the size of the issuer, within specified ranges, but the issuer is permitted not to disclose even this limited information” Aguilar, *supra* note 17.

<sup>83</sup> Aguilar, *supra* note 17.

2. *Outdated Accredited Investor Standard*

Under current Reg. D rules, issuers are permitted to solicit retail investors for their Rule 506 offerings, provided the investors qualify as “accredited” investors.<sup>84</sup> As defined in Reg. D Rule 501, an individual qualifies as an “accredited” investor with either an annual income of \$200,000 or a net worth of \$1,000,000,<sup>85</sup> excluding his or her residence.<sup>86</sup> “Currently, a natural person may qualify as an accredited investor solely on the basis of income or net worth, without regard to any investment experience or financial sophistication.”<sup>87</sup> The purpose of the accredited investor standard is to provide individuals with “financial sophistication” the freedom to invest in a wider range of investment vehicles, and the SEC operates with the assumption “that the purchaser actually has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment.”<sup>88</sup>

The Rule 501 standard sets forth, along with FINRA Rule 2111, a requirement that a stockbroker or other financial intermediary must determine the suitability of an investment for a particular individual.<sup>89</sup> This means that a financial intermediary that is subject to the rules set forth by FINRA, such as a broker-dealer or finder, must ensure that, based on the investor’s financial and investing sophistication, the private placement is suitable for the investor. Therefore, essentially any individual who meets the financial sophistication requirements is able to participate in these risky investments, provided that his or her stockbroker deems that the investment is suitable.<sup>90</sup> However, although these additional suitability

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<sup>84</sup> *Id.*

<sup>85</sup> 17 C.F.R. § 230.501(a)(5),(6) (Westlaw 2015).

<sup>86</sup> See Section 413(a) of The Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C.A. § 5301 et seq., (Westlaw 2015), full text of the Act available at <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf> (last visited June 14, 2015).

<sup>87</sup> Aguilar, *supra* note 17.

<sup>88</sup> *Id.*

<sup>89</sup> FINRA Rule 2111’s “reasonable basis” suitability analysis requires the BD to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, the “customer specific suitability” analysis requires that the BD determine whether the security is suitable for the customer to whom it would be recommended. FINRA Rule 2111, Suitability, available at [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=9859](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9859) (last visited May 26, 2015).

<sup>90</sup> “Over the past few years, thousands upon thousands of retail investors . . . have lost billions of dollars in risky private placements solicited by stockbrokers. Compared with sales in the public markets, brokers get a much higher commission when selling private placements, giving them an incentive to market them aggressively.” Johnson, *supra* note 3, at 995.

requirements are applicable to financial intermediaries, they are not applicable to non-financial or non-fund issuers.<sup>91</sup>

Between the years of 2009 and 2012, only 13% of Reg. D offerings reported using a financial intermediary, which indicates that over 80% of Reg. D offerings were issued by non-financial and non-fund issuers—i.e., private companies.<sup>92</sup> Because private companies are not subject to the additional rules and scrutiny of FINRA, the opportunity for a fraudulent issuer to solicit and defraud an uninformed “accredited” investor with little to no knowledge or sophistication in investing is further increased.

In addition, when an issuer of a Rule 506 offering solicits an individual who meets the accredited investor standard, the issuer is not required to provide the accredited investor with an information statement or disclosure of any kind.<sup>93</sup> Under the accredited investor standard using annual income and net worth, approximately 8.7 million U.S. households in 2010 qualified.<sup>94</sup> However, the SEC’s Division of Economic and Risk Analysis estimates that currently only a small percentage of U.S. households that meet the definition of accredited investor actually have substantial holdings of securities.<sup>95</sup> This suggests that a substantial portion of those that meet the accredited investor definition may actually have limited experience with investing in securities.<sup>96</sup>

Since the adoption of Rule 501 and the accredited investor definition in 1982, the economy has changed significantly and the characteristics initially intended to be attributed to those qualified as accredited investors no longer apply.<sup>97</sup> This outdated definition no longer satisfies the goal that it was originally intended to achieve, resulting in easier access for fraudulent issuers to reach a market of investors especially vulnerable to fraud due to lack of experience in the securities markets.<sup>98</sup> Thus, this

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<sup>91</sup> A non-financial issuer is typically a private company that issues its own securities, and a non-fund issuer is an issuer that is not a pooled investment fund and is not in the following Form D listed industries: commercial banking, insurance, investing, investment banking, and other banking and financial services. IVANOV & BAUGUESS, *supra* note 42, at 3 & n.3.

<sup>92</sup> *Id.* at 3.

<sup>93</sup> 17 C.F.R. § 230.506 (Westlaw 2015); *see also* Aguilar, *supra* note 17.

<sup>94</sup> Aguilar, *supra* note 17.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> “Generally, accredited investors possess substantial resources and are presumed to have the ability to fend for themselves in a securities transaction without the protection of the Securities Act.” Dravis, *supra* note 4, at 299.

<sup>98</sup> “[T]he definition of accredited investor is not limited to experienced or sophisticated investors. An individual with annual income of \$200,000 or net worth of \$1,000,000 may be considered well off, but those benchmarks are not necessarily correlated with financial expertise. In fact, the SEC’s Division of Economic and Risk Analysis estimates that only a small percentage of U.S. households meeting the definition of accredited investor have substantial direct holdings of individ-



expansive accredited investor standard exposes unsuspecting investors who lack the supposed sophistication to a high-risk market in which transactions are occurring with little to no information provided.

### 3. *Dangers of General Solicitation and Advertising*

In addition to the minimal reporting requirements and outdated accredited investor standard in place, the SEC's promulgation of the mandated amendments set forth in the JOBS Act has created a wider reach for fraudulent issuers with the allowance of general solicitation and advertising for Rule 506 exempt offerings. However, this allowance is predicated on whether the issuer has filed a Form D claiming the Rule 506(c) exemption, all investors solicited are accredited investors, and the issuer has taken reasonable steps to verify and has a reasonable belief that the investors are accredited.<sup>99</sup> Outside of those requirements, the SEC has not imposed any additional information filing requirements for issuers engaging in Rule 506(c) offerings, while allowing issuers to access a wider pool of investors.<sup>100</sup> Even the SEC recognized a higher risk of vulnerable investors being mass targeted after the adoption of the amendment, acknowledging that "[e]liminating the prohibition against general solicitation could result in heightened fraudulent activity in Rule 506(c) offerings because it will be easier for promoters of fraudulent schemes to reach potential investors through general solicitation."<sup>101</sup> Thus, despite the SEC's acknowledgement of the significant risks involved and the "significant data and informational limitations" imposed on the SEC,<sup>102</sup> the mandated amendments have been promulgated without providing additional safeguards to unsuspecting and inexperienced investors, who may fall victim to fraudulent offering schemes.

### 4. *Dangers in the Shortened Resale Period and Increase in Threshold for Registration*

Currently, an investor in a Rule 506 offering receives restricted securities that cannot be resold until the securities qualify for the Rule 144

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ual securities, suggesting that their experience investing in securities may be limited." Aguilar, *supra* note 9. "The SEC states that in 2010 approximately 8.7 million U.S. households, or 7.4 percent of all U.S. households, qualified as accredited investors based on that net worth standard in the definition of accredited investor." Stephenson & Hanks, *supra* note 34.

<sup>99</sup> 17 C.F.R. § 230.506 (Westlaw 2015); *see also* Aguilar, *supra* note 17.

<sup>100</sup> "The Commission is going ahead with the adoption of Rule 506(c), but only proposing the changes that would help mitigate the harm to investors." Aguilar, *supra* note 9.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

resale safe harbor.<sup>103</sup> Since the amendment in 2007, after a minimal one-year holding period,<sup>104</sup> an investor can generally resell the restricted securities, relying on Rule 144, to anyone, even those that do not qualify as accredited investors.<sup>105</sup> Therefore, after a short holding period and no additional information reporting requirements imposed on the issuer, a high-risk private placement investment in a potentially fraudulent corporation can be resold to any investor regardless of financial sophistication or investment experience. By permitting essentially free resale of potentially fraudulent private placements, Rule 144 not only fails to protect those investors that meet the accredited investor standard, but also fails to protect investors with little to no knowledge about private placement offerings trading on the secondary markets. The ease of resale in restricted securities, in combination with the allowance of general solicitation and advertising for Rule 506 offerings, has raised questions as to whether conditioning of the secondary trading market for Rule 506 private placements will occur once they can be resold.<sup>106</sup>

Revising Section 12(g)(1) of the Exchange Act<sup>107</sup> to raise the threshold for registration has also brought about problems with the issuance and trading of private placements. With the shareholder trigger now raised to 2,000, corporations can raise a significant amount of funds in Rule 506 offerings from thousands of investors without having to comply with the information filing and registration requirements set forth in the Securities Act. Thus, as a result of the collective rules and amendments, an issuer is permitted to conduct a Rule 506 offering of an unlimited dollar amount with minimal information filing requirements, while soliciting up to 2,000 accredited investors; many of these solicited investors do not have the requisite knowledge and experience required to make informed investment decisions with high-risk securities such as these. Furthermore, with the minimal Rule 144 resale period and heightened threshold for registration, restricted securities are easily resold, which could also result in fraud and manipulation in the secondary market.

Currently, the regulations and standards in place are flawed in their ability to achieve the government's primary goal of investor protection in the securities markets. The series of enactments and amendments affecting the offer and resale of Rule 506 private placements has caused the overall regulation of private placements to stray from the primary policy

<sup>103</sup> 17 C.F.R. § 230.144 (Westlaw 2015); *see* Aguilar, *supra* note 17.

<sup>104</sup> If the corporation is an Exchange Act reporting issuer, the holding period is six months. If the corporation is a non-reporting private issuer, the holding period is one year. Aguilar, *supra* note 17.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> 17 C.F.R. § 240.12g-1 (Westlaw 2015).

of investor protection and instead resulted in inadequate safeguards and increased investor vulnerability.

B. RESULTING FRAUD IN RULE 506 OFFERINGS AND RESALE

1. *Fraud in Rule 506 Offerings*

As a necessary instrument in fundraising for small and emerging businesses, Rule 506 has enabled legitimate companies to raise money; however, this exemption has also been used for significant fraudulent activities.<sup>108</sup> The SEC has reported that in 2011 the SEC and state regulators collectively filed more than 324 enforcement actions related specifically to Rule 506 offerings.<sup>109</sup> Furthermore, Rule 506 offerings have been ranked “as the most common vehicle for fraud, as they are highly illiquid, and lack transparency and regulatory oversight.”<sup>110</sup> The State of South Carolina has reported fraudulent Rule 506 offerings as the number one complaint in the attorney general’s office, and the State of Montana has reported that investors have lost more than \$100 million due to fraudulent Rule 506 offerings in the two most recent years for which statistics are available.<sup>111</sup>

With the new amendments in place permitting general solicitation and advertising, the risk of fraud in Rule 506 offerings has increased, with fraudulent issuers having a wider pool of investors. Investor advocates have voiced concern that investors will be targeted with information that is difficult to substantiate;<sup>112</sup> furthermore, along with the inadequate accredited investor standard, those inexperienced individuals susceptible to fraud will be targeted and defrauded in risky private placement offerings.<sup>113</sup> The collective rules and amendments affecting Rule 506 private placement offerings opened gaps in the regulation, resulting in heightened risk to investors and inadequate safeguards for investor protection.

2. *Fraud in Rule 506 Resale*

As an aid for small businesses raising capital, Rule 144 creates a safe harbor in which restricted securities, specifically those issued in a

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<sup>108</sup> Aguilar, *supra* note 20.

<sup>109</sup> *Id.*

<sup>110</sup> Richard Hill, *NASAA Cites Dangers Made Possible by JOBS Act in Releasing Top Threats List*, Sec. L. Daily (BNA) (Oct. 15, 2013).

<sup>111</sup> Aguilar, *supra* note 20.

<sup>112</sup> Stephenson & Hanks, *supra* note 34.

<sup>113</sup> Johnson, *supra* note 3, at 995.

Rule 506 offering, may be resold once a one-year holding period has passed and certain other requirements are met.<sup>114</sup> However, trading in the secondary market of securities, or the over-the-counter (OTC) market,<sup>115</sup> is very risky and has been a significant source of fraud with respect to securities offerings.<sup>116</sup> From 2003 to 2010, there have been seventy-five alleged violations involving OTC-traded issuers in securities offerings.<sup>117</sup> With the current inadequate standards in place, the risk of fraudulent activity in the resale of Rule 506 offerings on the OTC market has increased, namely in the OTC Pink Marketplace.

In contrast to securities listed on U.S. stock exchanges, securities on the OTC Pink may trade without being registered with the SEC.<sup>118</sup> Currently, for an issuer to become listed on OTC Pink, it must first have its broker-dealer quote the company on an Alternative Trading System (ATS) and submit a Form 211,<sup>119</sup> which contains minimal information, with FINRA as part of the process to obtain a Ticker Symbol.<sup>120</sup> After thirty days have passed, this stock becomes “piggyback qualified” and obtains a Symbol, and any broker-dealer from that point on may begin quoting the stock without filing another Form.<sup>121</sup> This means that after the minimum one-year Rule 144 holding period and additional thirty days on the ATS, a Rule 506 issuer’s private placements may then be freely quoted and traded on the OTC Pink. The minimal requirements currently imposed provide issuers and stock promoters with the opportunity to engage in manipulative and fraudulent trading of Rule 506 private placements on the secondary markets.<sup>122</sup> In permitting companies to issue private placements, with little transparency, to up to 2,000 accredited investors, the resale of which provides the potential for issuers to release

<sup>114</sup> 17 C.F.R. § 230.144 (Westlaw 2015).

<sup>115</sup> The OTC market is designed for and made up of companies with small amounts of assets and low stock prices. Companies listed on the OTC markets do not have to apply for listing or meet any minimum financial standards. *Microcap Fraud*, U.S. SEC. & EXCHANGE COMMISSION, [www.sec.gov/spotlight/microcap-fraud.shtml](http://www.sec.gov/spotlight/microcap-fraud.shtml) (last modified May 26, 2015).

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Reporting Requirements*, OTC MARKETS, [www.otcmarkets.com/learn/otc-company-reporting](http://www.otcmarkets.com/learn/otc-company-reporting) (last visited May 26, 2015).

<sup>119</sup> FINRA, FORM 211 (2014), available at [www.otcmarkets.com/content/doc/form-211.pdf](http://www.otcmarkets.com/content/doc/form-211.pdf).

<sup>120</sup> *How to Get Traded*, OTC MARKETS, [www.otcmarkets.com/learn/otc-trading](http://www.otcmarkets.com/learn/otc-trading) (last visited May 26, 2015).

<sup>121</sup> *Id.*

<sup>122</sup> Kevin C. Bartels, Note, “Click Here To Buy the Next Microsoft”: *The Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor*, 75 IND. L.J. 353, 356, (2000); see also *The Scary Rise of Internet Stock Scams* for the story of Michael Bowin, a fraudster who set up an Internet site at no cost and made \$190,000 in profit from a variety of defrauded investors before being caught by the SEC. Katrina Brooker, *The Scary Rise of Internet Stock Scams*, FORTUNE, Oct. 26, 1998, at 187, available at [http://archive.fortune.com/magazines/fortune/fortune\\_archive/1998/10/26/250019/index.htm](http://archive.fortune.com/magazines/fortune/fortune_archive/1998/10/26/250019/index.htm).

false information or engage in market manipulation schemes to inflate their stock prices, thus further increasing dangers to investors with no adequate safeguards put in place to protect them.

### III. SUGGESTIONS FOR AMENDING EXISTING RULE 506

Fraudulent Rule 506 offerings rank as the most common vehicle for securities fraud,<sup>123</sup> and now Congress and the SEC have allowed fraudsters to penetrate a larger population through general solicitation. SEC Commissioner Luis A. Aguilar pointed out that this could actually inhibit the JOBS Act's goal of capital formation, because "an increase in fraud in this market would harm investors who are defrauded, would undermine investor confidence in Rule 506 offerings and could negatively affect capital raising by legitimate issuers . . . reducing investor participation in Rule 506 offerings."<sup>124</sup>

This Part will set forth suggested amendments designed to heighten standards for investor protection, while maintaining the ease of access to capital for corporations engaging in Rule 506 offerings. The goal of the suggested amendments is to make the existing regulations more comprehensive and effective, without imposing more regulation on legitimate private placement issuers, thus, achieving a balance that can facilitate investor participation in the private placement market.

#### A. AMENDING THE FILING REQUIREMENTS

The first step toward increasing investor protection would be to amend the filing requirements currently imposed on private placement issuers. Currently, the filing of a Form D is only a condition to claiming a Rule 506(c) offering in which the corporation plans on engaging in general solicitation and advertising; when engaging in a classic Rule 506(b) offering, the filing of a Form D is not a condition to claiming the exemption.<sup>125</sup> However, as SEC Commissioner Luis A. Aguilar pointed out, "the potential value of a filing of Form D could be significantly enhanced, at little expense to the issuer, by modestly expanding the information required to be provided on the form."<sup>126</sup> The increased amount of information issuers should be required to provide would allow SEC regulators to more easily ascertain the legitimacy of an issuance while not imposing a greater burden on the issuer. The additional infor-

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<sup>123</sup> Hill, *supra* note 110.

<sup>124</sup> Aguilar, *supra* note 17.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

mation required would include the following: the financial size of the issuer, the number of and sophistication of potential investors, names and traceable information of the controlling persons of the corporation and any associated persons, and some minimal documentation confirming the existence of the functioning operation for which the funds are being raised. The filing of a Form D should be a condition for any company to claim any Rule 506 exemption. Also, a one-year automatic disqualification from engaging in Rule 506 offerings should be imposed on any issuer that either fails to file a Form D, or files a false or misleading Form D, as some have proposed.<sup>127</sup>

Applying these proposed amendments to the filing requirements currently in place would aid the SEC in ascertaining the legitimacy of Rule 506 private placement offerings. This would aid in reducing the possibility of undetected fraudulent offerings, while maintaining an adequately minimal reporting requirement on newly formed businesses seeking to raise capital.

#### B. AMENDING THE ACCREDITED INVESTOR STANDARD

Regardless of whether the reporting requirements imposed on Rule 506 issuers are heightened, the sophistication of investors targeted for fraudulent offerings is a significant issue. As previously discussed, the current standards in place for an individual to qualify as an accredited investor are outdated and substantially inadequate. Although there have been suggestions for amending this standard, these proposals are not enough, as these proposals and the standard as currently applied do not address the central issue: whether the investor has the necessary sophistication to evaluate the merits and risks of an investment and protect himself or herself in a highly illiquid and volatile market that lacks transparency and regulatory oversight.<sup>128</sup> Currently, a significant number of the individuals who are deemed to qualify as accredited investors under the rule have little to no investment experience or financial sophistication whatsoever.<sup>129</sup>

The accredited investor standard as applied to Rule 506 private placement offerings through Rule 501(a) should be amended so as to take into consideration the actual sophistication of each individual investor, regardless of the type of issuer. The standard to be applied should follow the standard set forth by courts when ruling on Rule 10b-5

<sup>127</sup> Yin Wilczek, *SEC's Reg D Proposal Runs Counter to JOBS Act Aims, Lawyers, Market Reps Say*, Sec. L. Daily (BNA) (Sept. 24, 2013).

<sup>128</sup> See Hill, *supra* note 110; see also Aguilar, *supra* note 17.

<sup>129</sup> Aguilar, *supra* note 17.

cases<sup>130</sup> and should take into consideration the following: the investor's education and special expertise in business, banking, or securities investments; the investor's income and net worth, with the minimum requirements increased to reflect inflation; the investor's own securities holdings, with an adequate minimum value imposed relative to income or net worth; and the background of the investor's securities holdings, with an adequate minimum length of time to help reflect investment experience.

By amending Rule 501(a) to reflect these minimal requirements to qualify as an accredited investor for the purposes of Regulation D private placement offerings, the individuals who are targeted for these investments would actually possess the level of sophistication that the original 1982 standard intended to apply.<sup>131</sup> This would inhibit fraudsters from reaching individuals who do not have the requisite sophistication to make informed decisions regarding these risky investments. It would also impose a minimal additional burden to issuers, and it would impose no heavier burden on the SEC, while facilitating its efforts to easily and effectively regulate with a more accurate assumption that the individual accredited investor actually has the necessary sophistication.

#### C. RESALE REFORM

Rule 144 creates a safe harbor that allows the resale of restricted securities from Regulation D offerings after a holding period of one year,<sup>132</sup> thus impliedly permitting the resale of Rule 506 private placements on the OTC market. With the current regulations in place, allowing for general solicitation and advertising, the risk of fraudulent practices in the resale of private placements is heightened.<sup>133</sup>

The SEC and Congress should amend the current requirements in place and require stricter guidelines and standards for an issuer to obtain

<sup>130</sup> Robert Connolly, Comment, *Legitimizing Private Placement Broker-Dealers Who Deal with Private Investment Funds: A Proposal for a New Regulatory Regime and a Limited Exception to Registration*, 40 J. MARSHALL L. REV. 703, 722 (2007).

<sup>131</sup> "The SEC has long operated under the principle that accredited investors do not need the same types of protections as the general public. They are assumed to have the sophistication to understand the terms of a securities offering and the ability to sustain a complete loss of the investment." Stephenson & Hanks, *supra* note 34.

<sup>132</sup> 17 C.F.R. § 230.144 (Westlaw 2015).

<sup>133</sup> The OTC Market is actually a three-tiered marketplace that includes the OTC QX, the OTC QB, and the OTC Pink. Each tier is distinguished based on the quality and quantity of information the companies make available. The OTC Pink marketplace is designed for all types of companies that are there by reason of "default, distress or design"; the OTC Pink does not have any qualification, registration, or reporting requirements. *Our Three Tiered Marketplaces*, OTC MARKETS, [www.otcmarkets.com/learn/otc-market-tiers](http://www.otcmarkets.com/learn/otc-market-tiers) (last visited May 26, 2015); see also *How to Get Traded*, *supra* note 120.

a Ticker Symbol and gain access to trading on the OTC Pink Marketplace. The information requirement on Form 211 is minimal, requesting only general information that a fraudster can easily misrepresent. Furthermore, this Comment proposes that FINRA impose more regulatory oversight when making determinations and assignments of Ticker Symbols to broker-dealers acting on behalf of issuers. Many issuers fraudulently act as stock promoters, or hire stock promoters, that find it relatively easy and inexpensive to tout stocks in various “pump and dump” schemes.<sup>134</sup> This results in falsely inflated share prices that profit the issuers and stock promoters, defrauding unsuspecting investors that responded to the sudden sharp demand in a highly volatile marketplace.<sup>135</sup>

With amendments to Form 211 requiring additional information from the issuers, FINRA would be aided in ascertaining the legitimacy of the securities being offered on the OTC Marketplaces, thus reducing the possibility of fraudulent trading activity while maintaining adequately minimal reporting requirements for those wishing to trade on the OTC Pink. Furthermore, if FINRA were to increase its oversight with respect to the assignment of Ticker Symbols and initial quotation of securities on the ATS, issuers and stock promoters would be inhibited from engaging in their fraudulent stock inflation strategies, as FINRA would more easily be able to detect these types of activities on the OTC Pink.

#### CONCLUSION

In the evolution of the securities markets since the adoption of the Securities Act in 1933, “Regulation D has played an important role in creating a well-understood set of rules relating to the offering of securities in transactions that are not subject to registration under the Act.”<sup>136</sup> During this same period of time, the economy has progressed and the Rule 506 exemption has been increasingly utilized by large and small corporations alike with the same goal:<sup>137</sup> raising capital to build their dream, albeit a risky dream, with the vast majority of Rule 506 private placement offerings representing legitimate fundraising efforts by growing business entities.<sup>138</sup> However, at the same time, the Rule 506 exemption has also resulted in significant fraudulent activities in the offer and resale of these high-risk securities by issuers and stock promoters at-

<sup>134</sup> Bartels, *supra* note 122, at 357.

<sup>135</sup> *Id.* at 356.

<sup>136</sup> Dravis, *supra* note 4, at 307.

<sup>137</sup> Sjostrom, *supra* note 45, at 1146.

<sup>138</sup> Johnson, *supra* note 3, at 1009.



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tempting to make a “quick buck” at the expense of the unsuspecting investor.<sup>139</sup>

Currently, there is a regulatory tug-of-war between the need to facilitate capital formation in the private securities market and the need to protect investors from fraud and manipulation; however, as the law currently stands, Congress and the SEC have yet to strike that balance. This Comment has provided the background and explanation of the collective amendments enacted since the adoption of the Securities Act that affect Regulation D. It then discussed how these amendments have resulted in significant fraud and increased investor vulnerability in the private placement market. Finally, this Comment provided suggested amendments to existing regulation in order to provide a clearer, more comprehensive set of guidelines to promote increased investor protection while maintaining the relative ease of regulatory filings for issuers to conduct Rule 506 offerings.

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<sup>139</sup> Aguilar, *supra* note 20.