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On July 10, 2013, for the first time in thirty-one years, the Securities and Exchange Commission ("SEC") substantively amended Regulation D, Rule 506 ("Rule 506"),[1] an exemption from the registration of securities offerings under the Securities Act of 1933 (the "33 Act").[2]

To most, this would scarcely merit notice. Who can keep up with all the overly technical financial and securities regulatory shakeups of this era? What do any of them really mean to the average investor anyway? Perversely, the law that mandated this amendment, the Jumpstart Our Business Startups Act (the "JOBS Act"), garnered significant public and press attention, although not for Title II, the portion of the Act that precipitated the July 2013 amendment.[3] Innocuously entitled "Access to Capital for Job Creators," Title II required the SEC to, among other things, lift the prohibition on general solicitation long associated with Rule 506 offerings.[4]

Title II's commandment engendered a radical about-face with respect to a very old exemption from registration for so-called "private offerings" of unlimited size under the 33 Act. This about-face was so radical that this Comment was first conceived as little more than an indictment of Title II

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* Florida International University College of Law, J.D. candidate 2015. This Comment is dedicated to my family, whose unconditional love and support sustain me, and to my mother, of whom I am proud beyond measure. Deepest thanks to Professor José Gabilondo for reviewing an earlier draft of this Comment; your kindness and wisdom are incomparable.

1 *See generally* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, 78 Fed. Reg. 44,771 (July 10, 2013) [hereinafter Rule 506(c) Adopting Release].

2 *See id.* "Regulation D" refers to a set of SEC-promulgated rules, codified at 17 C.F.R §§ 230.501-.508, under the 33 Act. Rule 504, Rule 505, and Rule 506 all provide specific exemptions from registration of offerings of securities under the 33 Act. *See* 17 C.F.R. §§ 230.504-.506 (2014). Rule 506 is the subject of this Comment. Rule 501, Rule 502, Rule 503, Rule 507, and Rule 508 of Regulation D set forth certain terms and conditions applicable to the three Regulation D exemptions. *See* 17 C.F.R. §§ 230.501-.503, .507-.508 (2014).

3 The JOBS Act, signed into law April 5, 2012, was newsworthy because it permitted, for the first time, "crowdfunding," a method of capital formation which is very much a creature of our age. *See generally*, Leigh Ann Caldwell, *Obama Signs "JOBS Act" into Law, Calls It a "Game-Changer"*, CBS NEWS (Apr. 5, 2012, 3:55 PM), http://www.cbsnews.com/news/obama-signs-jobs-act-into-law-calls-it-a-game-changer; *Small Business and the SEC: Crowdfunding*, SEC.GOV, http://www.sec.gov/info/smallbus/qasbsec.htm#crowdfunding (last modified Feb. 27, 2014).

4 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313-15 (2012).

and the lifting of the Rule 506 prohibition against general solicitation. Having worked in an industry[5] whose bread-and-butter is Rule 506 offerings, it seemed impossible, or at least highly improbable, that the general solicitation prohibition would ever *not* be a part of the Rule. The prohibition, though sometimes bemoaned, was that much a part of that industry's atmosphere, its very horizon.

And yet, as I commenced my research, I realized ending the ban on general solicitation was but a symptom of a much greater systemic change. The altering of Rule 506 at Congress's behest did not just, perhaps imprudently, "modernize" an old and outmoded exemption—it altogether discarded a long-standing and complex regulatory judgment that artfully balanced efficient capital formation and investor protection. It substituted for that judgment a problematic urgency that encourages issuers to raise as much capital, from as many investors, with as little regulation as possible, whatever the consequences.

This Comment is divided into two parts: the first accesses Rule 506 from a textual standpoint, while the second considers Rule 506's extra-textual historical development and its present-day realities. Together, these analyses provide a clear picture of the philosophical disjunction between the original and new components of the Rule; they demonstrate the new, fundamentally different regulatory calculus now embedded in Rule 506.

Part I is focused on the mechanics and text of Rule 506. It first situates Rule 506 within the vast universe of U.S. federal and state securities regulation. With that basic foundation laid, Part I continues by examining current Rule 506 (which contains both Rule 506(b), the original Rule 506 exemption, and Rule 506(c), the "new" Rule 506 exemption inaugurated by the JOBS Act). A close reading of Rule 506(b)'s text demonstrates that three principles underpin it: (1) investor protection, (2) egalitarianism, and (3) fairness. As a result, Rule 506(b) effectively balances the goal of efficient capital formation with the ameliorative aims of all securities regulation and more. Rule 506(c) abandons this balance for a less effective investor protection mechanism animated by a fundamentally different regulatory rationale.

Part II steps away from the text and interrogates two problem areas in and around Rule 506(c): (1) its novel, exclusive reliance on the accredited investor concept; and (2) the faulty legislative narrative that led to its promulgation. The practical and historical analyses contained in Part II highlight the particular problematics, or "stress points," Rule 506 encompasses today. These stress points independently evidence the new regulatory calculus Rule 506(c) embodies.

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5 Private investment funds (specifically hedge funds).

Finally, Part III contains my concluding remarks and an enumeration of certain issues connected with Rule 506(c) I believe need immediate attention to ensure the exemption becomes and stays a workable one.

I. MINING THE TEXT: WHAT RULE 506 SAYS

My goal is to closely read and examine the text of Rule 506 to unpack the principles animating the original Rule and then to determine whether those principles persist in new Rule 506(c). However, before closely examining the text, it is critical to have a working understanding of what Rule 506 *is*. Unfortunately, like most securities laws and rules, discussion of Rule 506 is usually either confined to a general definition[6] or treated in highly technical language.[7] Though both approaches, in the appropriate context, can be useful, neither is particularly helpful to a legal reader or, more importantly, a lay investor unacquainted with securities regulation. This is particularly true in the context of this Comment, which aims to engage with Rule 506 and both its old and new components in a fundamental way.

Accordingly, Part I begins with a "crash course" in the regulation of securities offerings in the U.S., then narrows its focus to Rule 506, which is but a single star in a far-flung firmament. This overview is intended to set the stage for the reader. With a thorough understanding of where Rule 506 "fits" in the grander scheme, Rule 506's text may be further explored and mined for meaning.

A. A Crash Course in U.S. Securities Regulation

By default, offerings of securities must be registered under state or federal laws.[8] Although "offering" is not defined in either the 33 Act or Regulation D,[9] "offer" is. Under the 33 Act, an offer "shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[10] This definition was clearly designed to encompass, and does in fact encompass, a broad swath of transactions. A

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6 *See, e.g.*, *Regulation D Offerings*, SEC.GOV, https://www.sec.gov/answers/regd.htm (last modified Oct. 28, 2014).

7 *See, e.g.*, Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355 (1984).

8 The U.S. securities system is truly a federal system. The federal securities acts (which include, among others, the 33 Act, the Securities Exchange Act of 1934, and the Investment Company Act of 1940) are administered by the SEC. Each state also has its own securities act (*see, e.g.*, Fla. Stat. §§ 517.011-.032 (2014)), which is administered by a state securities administrator. The provision of the federal securities laws compelling the registration of an offering of securities is section 5 of the 33 Act. *See* 15 U.S.C. § 77e (2014).

9 *See supra* note 2 and accompanying text.

10 15 U.S.C. § 77b(a)(3) (2014).

convenient and accessible example of an "offer" is the sale by a corporate issuer of its common stock or of a series of its debt instruments, such as bonds or debentures.[11]

Registration at any level can be costly and cumbersome, so many issuers seek an exemption from registration. There are several exemptions built into the securities laws, both at the state and federal levels. Section 4 of the 33 Act provides a number of such exemptions.[12] Of these exemptions, that contemplated by section 4(a)(2)[13] is the authority for SEC-promulgated Rule 506.[14] Section 4(a)(2) provides that the registration provisions of the 33 Act shall not apply to "transactions by an issuer not involving *any public offering*."[15]

As an important aside, prior to 1996, an issuer's ability to claim—or actual claiming of—an exemption under the federal securities laws did not immunize the issuer from the registration requirements of the *states*' securities laws. Accordingly, where an issuer sought to offer securities in a particular state, even if that same offering was exempt from federal registration, the issuer would either: (1) have to seek a separate exemption under the state securities laws, or (2) register the offering under the state securities laws. It requires no great stretch of the imagination to comprehend the great time, effort, and expense that a federally exempted offering in, for example, multiple states (let alone *all fifty* states) entailed under this regime. It is similarly clear that the burdens of these requirements could fall disproportionately on small issuers, including small businesses.

Congress attempted to address this precise problem through the Small Business Investment Incentive Act of 1980 (the "SBIIA").[16] The SBIIA amended section 19 of the 33 Act to explicitly articulate a policy of cooperation between the SEC and the various state securities administrators.[17] Among the ends of the policy were the specific goals of

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11 The list goes on and on; offerings of limited partnership interests are an extremely common securities offering (particularly in the Rule 506 context). Many private investment companies (what the investing public and media typically refer to as "hedge funds") offer limited partnership interests to their investors through Rule 506 offerings.

12 *See* 15 U.S.C. § 77d (2014).

13 15 U.S.C. § 77d(a)(2) (2014). Prior to April 5, 2012 (the date the JOBS Act was signed into law), section 4(a)(2) was known as section 4(2). For purposes of this Comment, this section will be referred to as "section 4(a)(2)" throughout, including in historical contexts.

14 Technically, Rule 506 is a "safe harbor" under section 4(a)(2). *See* Rule 506(c) Adopting Release, *supra* note 1, at 44,772. This means "a company can be assured it is within the Section 4(a)(2) exemption" simply by showing good faith compliance with Rule 506's terms and conditions. *See Rule 506 of Regulation D*, SEC.GOV, http://www.sec.gov/answers/rule506.htm (last modified Oct. 6, 2014).

15 15 U.S.C. § 77d(a)(2) (2014) (emphasis added).

16 Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

17 15 U.S.C. § 77s(d)(1) (2014).

(1) minimum interference with the business of capital formation, and (2) "the development of a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government."[18]

Ultimately, this policy of cooperation engendered the drafting of Regulation D, including Rule 506, by the SEC in 1982.[19] Yet, the initial promulgation of Regulation D and Rule 506 did not resolve the latent tension and inefficiency stemming from the parallel and coextensive state and federal securities regulatory apparatuses. As section 19 of the 33 Act, as amended, continues to state: "The [SEC] shall have the authority [only] to adopt . . . [a uniform exemption for small issuers] for *Federal purposes*."[20] Additionally, "[n]othing in the [33 Act] shall be construed as authorizing preemption of State law."[21]

Unsurprisingly, then, in 1996, Congress enacted a further legislative initiative, the National Securities Market Improvement Act ("NSMIA"), as an arguably more definitive effort to dissolve cross-jurisdictional impediments to small business capital formation. NSMIA amended section 18 of the 33 Act to preempt "any State or any political subdivision thereof" from regulating, by law or rule, any "covered security."[22] Under amended section 18, a covered security includes, among other things, a security exempt from registration under the 33 Act by virtue of SEC rules or regulations issued under section 4(a)(2).[23] Accordingly, NSMIA's state preemption extends to Rule 506, which is an SEC-promulgated safe harbor under section 4(a)(2).

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18 15 U.S.C. § 77s(d)(2)-(3) (2014).

19 *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251-01 (Mar. 8, 1982) [hereinafter Regulation D Adopting Release (1982)]. As discussed further below, Rule 506 is unique among the Regulation D rules in that it does not condition its exemption on the offering raising no more than a specific total amount of capital. *See infra* p. 246. It is questionable whether an issuer who can raise an unlimited amount of capital is a "small issuer." Yet, the SEC, in the Regulation D Adopting Release (1982), curiously stated Regulation D, as a whole and inclusive of Rule 506, was intended to be the central element in a framework that was responsive to section 19 of the 33 Act, as amended by the SBIIA. *See* Regulation D Adopting Release (1982), at 11,251-52. This blurring of the distinction between a legitimately small issuer (who ostensibly should be the beneficiary of relaxed capital formation regulation) and other kinds of issuers has continued through the present, and, as discussed at length in Part II, significantly drove the congressional narrative behind Title II of the JOBS Act.

20 15 U.S.C. § 77s(d)(3)(C) (2014); *see also* Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 505, 94 Stat. 2275, 2293 (1980) (emphasis added).

21 15 U.S.C. § 77s(d)(3)(C) (2014).

22 15 U.S.C. § 77r(a), (b) (2014). Although states retained and continue to retain the authority to investigate and bring enforcement actions with respect to, among other things, fraud or deceit, in connection with securities or securities transactions. *See* Jill D. Meyer, *Federal Preemption of the Rule 506 Exemption*, 37 No. 2 SEC. REG. L.J. ART. 2 (2009).

23 15 U.S.C. § 77r(b)(4)(E) (2014).

In summary, the overarching regulatory state of play under Rule 506 is actually quite simple. So long as an issuer meets the requirements of Rule 506 with respect to an offering, that offering need not be registered under the federal securities laws. Further, because Rule 506 offerings are of "covered securities," the states are summarily preempted from regulating them.

A preliminary observation can be made at this point: Rule 506 is an extremely powerful exemption, for it removes an offering of securities from the ambit of both federal and state regulation. Though the state and federal governments retain the authority to investigate and prosecute fraud in a Rule 506 offering,[24] such an offering is cloaked with the presumption of legitimacy. The mechanics of the exemption actually potentially permit (and have permitted) fraudulent Rule 506 offerings to operate for an indefinite period of time, free from all regulatory scrutiny.[25] This has led at least one commentator to refer to Rule 506 offerings as a "regulatory black hole."[26]

B. Digging Deeper: Into the Text, from the Top Down

This is not to say Rule 506 is bereft of internal defenses to combat misuse and abuse. Similarly, neither the SEC nor Congress intended to authorize a far-reaching, blanket exemption that could operate wholly beyond the "salutary" effects of the securities laws.[27] As I suggested at the beginning of this Comment, one of the most critical of these defenses has been the ban on general solicitation.

However, before focusing on the regulatory, congressional, and other motivations behind Rule 506, it is important to understand *how Rule 506 actually works*. What does an issuer "get" when it claims the exemption? How does an issuer claim the exemption? What are the conditions for claiming it?

This subsection begins by answering these basic questions. This initial discussion will also disclose the embedded judgment (or merely acknowledge the reality) that Rule 506 offerings are, in general,

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24 *See* Meyer, *supra* note 22.

25 Such frauds include the CD component of the high-profile Stanford International Bank Ponzi scheme, Provident Royalties, LLC, and Medical Capital Holdings Inc. *See* Complaint at 10, SEC v. Stanford International Bank Ltd., No. 3-09CV0298-L (N.D. Tex. Feb. 17, 2009) (Stanford Ponzi scheme); Bruce Kelly, *B-D to Pay Clients $700K to Settle Private-Placement Suits*, INVESTMENT NEWS (Feb. 14, 2011, 2:15 PM), http://www.investmentnews.com/article/20110214/FREE/110219966/b-d-to-pay-clients-700k-to-settle-private-placement-suits (discussing Provident Royalties and Medical Capital Holdings frauds).

26 Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 155 (2010).

27 H.R. REP. 96-1341, at 20 (1980).

exceptionally risky, and that the appropriate method of managing that risk is not *regulating what those offerings do* (which is one kind of regulatory modus operandi), but *regulating who can access (and operate) them*. A second embedded judgment will emerge from this discussion: by and large, the rewards and benefits of the offerings covered by the Rule are worthwhile despite their risks, and investors should have access to these opportunities.

A close reading of original Rule 506, or Rule 506(b),[28] follows and shows that three specific concerns animated the Rule's drafting: (1) investor protection (specifically through limitation: limitation as to kinds of investors; participation by certain kinds of investors; manner of offering); (2) egalitarianism (i.e., Rule 506(b) investment opportunities should not solely be the province of the rich or the specially situated); and (3) fairness (all investors should be placed on equal footing with one another and with the issuer).

Finally, an examination of Rule 506(c) reveals all three of these principles are absent in that new Rule,[29] as it embodies an entirely different regulatory calculus.

1. Rule 506: The Basics

i. What the Issuer "Gets"

As discussed above, Rule 506 is a safe harbor under section 4(a)(2) of the 33 Act. Since September 23, 2013, the effective date of the July 2013 amendment, Rule 506 provides two paths to this safe harbor: Rule 506(b) is the original Rule 506 exemption, first promulgated by the SEC in 1982,[30] while Rule 506(c) responds directly to the JOBS Act's congressional mandate to eliminate the prohibition on general solicitation that continues to characterize Rule 506(b).[31] An issuer may claim either Rule 506(b) or Rule 506(c); the exemptive effect on the offering is largely the same, though the conditions associated with each differ in important ways.

Accordingly, when an issuer meets either exemption's requirements with respect to an offering, that offering is protected from registration pursuant to section 4(a)(2) of the 33 Act. Further, through operation of NSMIA, the state's regulatory gaze is preempted. In short, upon claiming a Rule 506 exemption with respect to an offering, an issuer receives

28 17 C.F.R. § 230.506(b) (2014).

29 17 C.F.R. § 230.506(c) (2014).

30 17 C.F.R. § 230.506(b) (2014); Regulation D Adopting Release (1982), *supra* note 19, at 11,261.

31 *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313-14 (2012).

immunity from regulation (excepting for fraud) of that offering at both the state and federal levels. Additionally, as Rule 506 is a *nonexclusive* safe harbor, an issuer may claim it while also relying on other exemptions.[32]

Rule 506 is unique in that it permits an issuer to raise an unlimited amount of capital.[33] Other Regulation D Rules—namely, Rule 504[34] and Rule 505[35]—limit the amount of capital that can be raised. The ability to raise unlimited capital, exclusive to Rule 506, is another reason why the Rule is so useful—and powerful.

ii. Procedure for Claiming the Exemption

Actually claiming an exemption under Rule 506 is a relatively simple matter. An issuer must comply with the specific conditions of Rule 506(b) or Rule 506(c) as well as certain general terms and conditions discussed more completely below. Then, the issuer must file a Form D with the SEC[36] and, typically, with any states where securities are sold.[37] The Form D is a "notice filing" to each regulator who receives it, not a registration statement. It requires the issuer to disclose, among other things, its name, address, related persons,[38] size (in terms of revenue range or, in the case of investment funds, aggregate net asset value range), and number of investors who have already invested in the offering (including a disclosure as to whether any are "nonaccredited").[39] The issuer must also disclose certain information about sales compensation, including the identity of the recipients of such compensation, who may or may not be associated with a broker-dealer.[40]

An amendment to an initially filed Form D is only required once annually (if the offering is continuing) and upon the occurrence of certain

32 For example, an issuer can simultaneously claim exemptions under both Rule 506 *and* section 4(a)(2), generally. In such an instance, if the issuer fails to establish that its offering complies with the terms of the Rule 506 safe harbor, the issuer may still be successful in showing its offering is exempt under section 4(a)(2) because it does "not involv[e] any public offering." *See* 15 U.S.C. § 77d(a)(2) (2014). However, because section 4(a)(2) is not a safe harbor, relying on it places the burden of proving the exemption on the issuer. Further, the securities of section 4(a)(2) offerings are not covered securities under section 18 of the 33 Act in the same way Rule 506 securities are: section 4(a)(2) is not an SEC rule or regulation. Accordingly, issuers relying on section 4(a)(2) lose the benefit of state regulatory preemption.

33 17 C.F.R. § 230.506 (2014).

34 17 C.F.R. § 230.504 (2014).

35 17 C.F.R. § 230.505 (2014).

36 17 C.F.R. § 230.503 (2014).

37 *See, e.g.*, 815 ILL. COMP. STAT. 5/2a (2014); ILL. ADMIN. CODE tit. 14, § 130.293(a)(1) (2014) (providing Illinois's notice-filing requirements for issuers relying on Rule 506).

38 These include individuals such as the issuer's executive officers, directors, and promoters.

39 *See SEC Form D*, at 1-4, https://www.sec.gov/about/forms/formd.pdf.

40 *Id.* at 3.

specific events.[41] Importantly, as of the date of this writing, filing a Form D or updating a previously filed Form D, even in the event of the termination or closing of a Rule 506 offering, is not a precondition of claiming an exemption under Rule 506.[42]

iii. General Terms and Conditions

As aforementioned, certain general terms and conditions outside of Rule 506(b) and Rule 506(c) must be observed or met to claim either exemption. These include: (1) the accredited investor concept, and (2) the bad actor disqualification. The former concept is articulated in Rule 501(a) of Regulation D,[43] while the latter was added to Rule 506 as Rule 506(d) effective September 2013.[44] Certain other relevant general terms and conditions can be found throughout Regulation D, though these are not covered exhaustively here.[45]

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41 *Id.* at 5. These specific events are: (1) "to correct a material mistake of fact or error in [a] previously filed notice, as soon as practicable after discovery of the mistake or error," and (2) to reflect a change in certain responses included in the form. *Id.* The Form D provides a list of response changes which do not trigger an amendment. *See id.*

42 On July 10, 2013, the SEC proposed further amendments to Regulation D to make filing and updating (including at the offering's closing) a Form D a requirement of the Rule 506 exemption. The proposed amendments would also change the timing of filings with respect to Rule 506(c) offerings. Instead of filing the Form D no more than fifteen days from the date of the first sale of securities, the proposed rules would require filing a Form D *no less* than fifteen days *prior to the day of first sale* (an "Advance Form D"). The Advance Form D would request less information than the full Form D, though the issuer would be obligated to complete the remainder of the Form D no more than fifteen days after the first sale of securities. *See* Amendments to Regulation D, Form D and Rule 156, Securities Act Release No. 33-9416, Exchange Act Release No. 34-69960, Investment Company Act Release No. IC-30595, 78 Fed. Reg. 44,806, at 44,810-11 (July 10, 2013) [hereinafter July 10, 2013, Proposing Release].

43 17 C.F.R. § 230.501(a) (2014).

44 17 C.F.R. § 230.506(d) (2014).

45 Certain of these general terms and conditions are discussed in conjunction with the close reading of Rule 506(b) and Rule 506(c). Still others are not comprehensively covered in this Comment, but remain important, such as the principle of integration and limitation on resale. *See* 17 C.F.R. § 230.502(a), (d) (2014). Though these last two are somewhat more procedural than the conditions discussed at length herein, they are both essential to all Regulation D offerings. Rule 502(a) provides for "integration" of securities sales into a single Regulation D offering under certain circumstances. 17 C.F.R. § 230.502(a) (2014). This means that a series of offers and sales made by an issuer over an extended period of time may be considered a single Regulation D offering. In order for the issuer to advantage itself of a Regulation D exemption, each offer and sale must individually meet the requirements of Regulation D. Accordingly, if any one offer or sale in an integrated offering does not comply with the requirements of Regulation D, the issuer may not be able to claim the Regulation D exemption. Whether two or more offerings will be deemed integrated generally depends on a fact-intensive analysis, though there are some temporal bright lines that issuers may rely on to sever multiple offerings from one another. Rule 502(d) limits the resale of Regulation D securities such that the securities may not be resold without being registered under the 33 Act or subject to some other exemption from registration. 17 C.F.R. § 230.502(d) (2014).

a. The Accredited Investor

Rule 501(a)'s definition of "accredited investor" is integral to the operation of Rule 506. Only accredited investors enjoy unlimited participation in offerings exempted from registration under either Rule 506(b) or Rule 506(c).[46] Accordingly, whether an investor is accredited can determine whether that investor may participate in a Rule 506 offering at all.[47]

Rule 501(a) contemplates eight categories of accredited investors and embraces both natural and non-natural persons (i.e., corporations, partnerships, and the like). These categories are all defined with reference to one or more of an investor's (1) net assets or net worth (that is, wealth),[48] (2) income,[49] or (3) status.[50] Though perhaps not apparent from the bare definitions of Rule 501(a), Regulation D's accredited investor concept embodies the presumption that individuals or entities, either due to their very nature or their wealth or income, can "fend for themselves" in offerings unfettered by the requirements of registration.[51] What constitutes the ability to fend for oneself has never been precisely defined; only over time did the accreditation categories become a proxy for the ability. Historically, the ability has been evidenced by the capacity (the "knowledge and experience" sufficient)[52] to appreciate and evaluate the risks and merits of an investment and, in certain cases, the ability to bear the economic risks associated with an investment.

It is increasingly doubtful the accreditation standards that hinge on wealth and income, in particular, continue to meaningfully represent either of the historical elements of the ability to fend for oneself. This is because the accreditation wealth and income thresholds have remained largely unchanged for thirty years despite the inexorable march of inflation.[53]

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46 Rule 506(b) (i.e., originally enacted Rule 506) also permits up to thirty-five nonaccredited "purchasers" to participate in a Rule 506(b) offering. 17 C.F.R. § 230.506(b)(2)(i) (2014).

47 *See* 17 C.F.R. § 230.506(b)(2)(i), (c)(2)(i) (2014).

48 *See, e.g.*, 17 C.F.R. § 230.501(a)(5) (2014).

49 *See, e.g.*, 17 C.F.R. § 230.501(a)(6) (2014).

50 *See, e.g.*, 17 C.F.R. § 230.501(a)(4) (2014) (accrediting directors, executive officers, and general partners of an issuer). "Status" may also refer to an entity's ability to fit within a certain statutory definition or registration status. For example, Rule 501(a)(1) accredits any bank as defined under section 3(a)(2) of the 33 Act. Rule 501(a)(1) also accredits "any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934." 17 C.F.R. § 230.501(a)(1) (2014).

51 The importance of investors' ability to "fend for themselves" in the context of offerings exempt under section 4(a)(2) was first articulated by the Supreme Court in 1953. *See infra* pp. 268-69.

52 17 C.F.R. § 230.506(b)(2)(ii) (2014). As discussed below, such knowledge and experience is also called investor sophistication. *See Rule 506 of Regulation D*, *supra* note 14 (defining sophistication as "hav[ing] sufficient knowledge and experience in financial and business matters to make [the investor] capable of evaluating the merits and risks of the prospective investment").

53 *See* July 10, 2013, Proposing Release, *supra* note 42, at 44,808.

Further analysis on this score will be provided in Part II. For now it is enough to say that the capacity to fend for oneself is one of the "tickets to ride" a Rule 506 offering, and accreditation remains a proxy for that ability.

Half of the eight Rule 501(a) categories are conditioned on investor wealth or income; these categories are located at Rule 501(a)(3), Rule 501(a)(7), Rule 501(a)(5), and Rule 501(a)(6).

Rule 501(a)(3) accredits corporations or partnerships, including nonprofit entities. For such an entity to be accredited, the entity must have "total assets in excess of $5,000,000."[54] Additionally, the entity must not have been "formed for the specific purpose of acquiring the securities offered."[55] Rule 501(a)(7) contains substantially identical conditions to Rule 501(a)(3), but accredits trusts as opposed to business entities.[56]

Rule 501(a)(5) accredits natural persons (individuals as well as individuals together with their spouses) on the basis of individual or joint net worth.[57] Where such a person (or such a person with his or her spouse) has a net worth (or joint net worth) in excess of $1,000,000, the person (with his or her spouse, as applicable) is an accredited investor.[58] Presently, the calculation of net worth must exclude the person's primary residence as an asset.[59] Similarly, any indebtedness secured by the person's primary residence (i.e., a mortgage) is excluded as a liability from the net worth calculation.[60]

Rule 501(a)(6) also accredits natural persons, but with reference to their individual (or joint, as the case may be) income.[61] Any person whose individual income for the two most recent years was in excess of $200,000, or any couple whose joint income for the two most recent years was in excess of $300,000, is accredited, provided the individual or couple has the reasonable expectation of reaching the same income level in the current year.[62]

The remainder of the accreditation categories focus on investor status,

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54 17 C.F.R. § 230.501(a)(3) (2014).

55 *Id.*

56 17 C.F.R. § 230.501(a)(7) (2014).

57 17 C.F.R. § 230.501(a)(5) (2014).

58 *Id.*

59 17 C.F.R. § 230.501(a)(5)(i)(A) (2014).

60 17 C.F.R. § 230.501(a)(5)(i)(B) (2014). Except to the extent where the secured indebtedness exceeds the estimated fair market value of the primary residence at the time of the sale of the Regulation D securities. 17 C.F.R. § 230.501(a)(5)(i)(C) (2014). For example, where the fair market value of a person's primary residence is, at the time of the person's purchase of Regulation D securities, $500,000, and the outstanding indebtedness secured by the residence (i.e., the mortgage) is $600,000, the person's net worth calculation must include the excess $100,000 as a liability.

61 17 C.F.R. § 230.501(a)(6) (2014).

62 *Id.*

ostensibly because certain status necessarily implies an investor has the knowledge and experience sufficient to evaluate the merits and risks of an investment.[63]

b. The Bad Actor Disqualification

The bad actor disqualification located at Rule 506(d) became effective alongside Rule 506(c) on September 23, 2013.[64] However, unlike Rule 506(c), the genesis of the bad actor disqualification was the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), not the JOBS Act.[65] Rule 506(d)'s intent is clear: to prevent individuals and entities who have already violated the law or run afoul of regulation from utilizing the powerful Rule 506 exemption.[66]

Prior to the promulgation of Rule 506(d), an issuer could not be precluded from claiming a Rule 506 exemption even if the issuer, or one of the issuer's affiliates,[67] had been convicted of, for example, a felony or misdemeanor in connection with the purchase or sale of a security.[68] Currently prohibited from utilizing Rule 506 by Rule 506(d) are issuers or persons affiliated with an issuer who have committed certain "bad acts," provided those bad acts occurred after September 23, 2013, the effective date of Rule 506(d).[69] Issuers are required to provide all investors a written disclosure of their and their affiliates' bad acts, if any, which occurred prior to September 23, 2013.[70]

Again, the rationale underlying the bad actor disqualification is simple: prevent individuals and entities known to have violated the securities laws and rules from advantaging themselves of an exemption that essentially immunizes them from regulatory scrutiny. It is unclear why the SEC did not promulgate such a disqualification from the outset.

It would be gratifying to interpret Rule 506(d) and Rule 506(c) as complementary provisions, considering their simultaneous promulgation. However, as mentioned above, they stem from different congressional mandates. It is nevertheless fortunate the bad actor disqualification is now in operation. Even so, considering many, if not most, prior acts receive

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63 *See supra* note 50.

64 Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 33-9414, 78 Fed. Reg. 44,730, 44,730 (July 10, 2013).

65 *Id.*

66 *Id.* at 44,730-33.

67 An issuer's affiliates include, among others, the issuer's officers and directors. *See* 17 C.F.R. § 230.506(d)(1) (2014).

68 17 C.F.R. § 230.506(d)(1)(i)(A) (2014).

69 17 C.F.R. § 230.506(d)(1), (2) (2014).

70 17 C.F.R. § 230.506(e) (2014).

"grandfathered" treatment under Rule 506(d) (i.e., they do not bar individuals who did bad acts prior to September 23, 2013, from claiming a Rule 506 exemption),[71] the disqualification's full impact will likely only be felt in years hence.

iv. Checkpoint: Synthesizing the Basics

Even before proceeding with a close reading of Rule 506's text, an understanding of the Rule's basics already illuminates some of its overarching aims and rationale.

A Rule 506 offering's liberation from federal and state regulation means there is no "cop on the beat"[72] initially or continuously monitoring the offering or its activity. Freed from the rigors of registration, Rule 506 issuers confront few regulatory limitations with respect to their underlying businesses and structures.[73] Consequently, issuers have an incredible degree of liberty in pursuing their capital-raising and business objectives. Unfortunately, this same liberty may also permit issuers to engage in unacceptable risk-taking or practices that could result in crippling insolvency or total collapse. Simultaneously, Rule 506 offerings are generally free of the paradigmatic affirmative obligation associated with registration: providing investors, initially or on an ongoing basis, information that would allow them to identify any such problematic activity for themselves.[74] As a result, Rule 506 naturally and purposely plays host to a bevy of speculative "start-up" or special purpose offerings, often without track records or any qualitative or quantitative data which could shed light on their prospects for success.

The unconstrained and oftentimes opaque nature of Rule 506 offerings necessarily implies a high level of risk. Regulatory authorities have quantified this risk as so much greater than that present in regulated securities offerings that they have determined only investors who can "fend for themselves" need apply. The exemption is so powerful that access to it has been denied to bad actors. Yet, Rule 506's continued existence is testament to the fundamental belief that these exempted offerings are necessary, and investors should have access to them. These basic

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71 17 C.F.R. § 230.506(d)(2)(i) (2014).

72 *See* Johnson, *supra* note 26, at 159.

73 This can be most starkly contrasted with registration by qualification or "merit review," a securities offering registration procedure common among the states. *See, e.g.*, Fla. Stat. § 517.081 (2014) (setting forth Florida's registration by qualification procedure).

74 In certain circumstances, Rule 506 does impose disclosure requirements. *See infra* pp. 256-58. However, these limited disclosure requirements are significantly less burdensome than those imposed on offerings registered under the 33 Act. *Compare SEC Form S-1*, http://www.sec.gov/about/forms/forms-1.pdf (registration statement required under the 33 Act), *with* 17 C.F.R. § 230.502(b) (2014) (information requirements under Rule 506(b) triggered by nonaccredited investor participation).

conclusions constitute the backdrop against which Rule 506(b) and Rule 506(c) should be judged. I contend, and demonstrate below, that Rule 506(b) does the best job of reconciling all of the foregoing by focusing on three regulatory concerns, while Rule 506(c)'s weaknesses stem from casting those concerns aside.

2. Close Reading, Part I: Rule 506(b) and Protection, Egalitarianism, and Fairness

We turn now to Rule 506(b), the first exemption in Rule 506 proper and the original Rule 506 exemption promulgated by the SEC in 1982.

To claim the exemption under Rule 506(b), an issuer must: (1) satisfy the general terms and conditions of Rule 501 and Rule 502;[75] (2) limit the amount of nonaccredited "purchasers" who participate in the offering, all of whom must meet an additional "knowledge and experience," or "sophistication," requirement;[76] (3) provide such nonaccredited purchasers with certain information regarding the offering;[77] and (4) observe the limitation on the "manner of offering" (i.e., the prohibition on general solicitation).[78]

Rule 506(b) evidences a regulatory philosophy of investor protection (through *limitation*; for example, on the *kinds* of investors who can participate) modified by egalitarian exceptions that provide individuals and entities who do not meet the accreditation wealth, income, or status requirements access to Rule 506(b) offerings. Rule 506(b) also expresses a third regulatory concern: fairness. Rule 506(b) creates a level playing field among investors (specifically, those participating through an egalitarian exception and those who are not) and the issuer by requiring the issuer to furnish certain information to certain investors.

i. Protection Through Limitation, Part I: No More than Thirty-Five Purchasers

Rule 506(b)(2)(i) requires that "[t]here are no more than or the issuer reasonably believes that there are no more than [thirty-five] purchasers of securities" in a given Rule 506(b) offering.[79] A note to Rule 506(b)(2)(i) directs the issuer to Rule 501(e) for instructions on how to count "purchasers."[80] Taken together, Rule 506(b)(2)(i) and Rule 501(e) function

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75 17 C.F.R. § 230.506(b)(1) (2014); *see also supra* note 45 and accompanying text.

76 17 C.F.R. § 230.506(b)(2)(i), (ii) (2014).

77 17 C.F.R. § 230.502(b) (2014); 17 C.F.R. § 230.506(b)(1) (2014).

78 17 C.F.R. § 230.502(c) (2014).

79 17 C.F.R. § 230.506(b)(2)(i) (2014).

80 *Id.*

as a Rule 506(b) offering's gatekeeper. While there is no limitation on the participation of individuals and entities who are *not* counted as purchasers under these provisions,[81] no more than thirty-five investors and entities who *are* counted as purchasers may participate.[82] Who is considered a purchaser, considered in conjunction with the accredited investor definition contained in Rule 501(a), discussed above, defines the dynamic balance between protective limitation and egalitarian access contained in Rule 506(b).

Any natural or non-natural person who acquires securities in an offering is a "purchaser."[83] However, Rule 501(e) operates to exclude certain purchasers from the total number of purchasers relevant for compliance with Rule 506(b)(2)(i) (the "Adjusted Purchaser Count").[84]

Most critically, all accredited investors are excluded from the Adjusted Purchaser Count. Additionally excluded are (1) the relatives, including the spouse and relatives of the spouse, who reside at the same primary residence of any other purchaser; and (2) certain corporations and other entities owned by a purchaser (or relatives of the purchaser who reside at the same primary residence of the purchaser).[85]

Some illustrative examples may be helpful. A nonaccredited woman, A, individually invests in a Rule 506(b) offering. Her husband, B, who is also nonaccredited, also individually invests in the same offering. Through operation of Rule 501(e), B is excluded from the Adjusted Purchaser Count solely because he is the spouse of A, who is considered a purchaser. The final Adjusted Purchaser Count in this example is one.

To expand this example, begin with the same facts as above. Ten additional persons purchase securities in the offering A and B are participating in. All ten persons are accredited. Again, through the operation of Rule 501(e), each of the ten investors is excluded from the Adjusted Purchaser Count, because each is an accredited investor. Although a total of twelve persons have invested in the offering, the total Adjusted Purchaser Count relevant for compliance with Rule 506(b)(2)(i) is still just one.

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81 *See* 17 C.F.R. § 230.501(e)(1) (2014).

82 17 C.F.R. § 230.506(b)(2)(i) (2014).

83 *See generally* 17 C.F.R. § 230.501(e) (2014).

84 *See* 17 C.F.R. § 230.506(b)(2)(i) (2014).

85 *See* 17 C.F.R. § 230.501(e)(1)(i), (iii) (2014). Rule 501(e) provides additional guidance for how to count non-natural persons. Generally, a corporation or other entity will be counted as a single purchaser (unless, of course, the corporation is itself an accredited investor and is therefore excluded from the Adjusted Purchaser Count). An exception to this general rule exists where the investing corporation or other entity has been created solely for the purpose of acquiring securities in the offering. In that case, each owner of equity interests in the investing entity is counted as a purchaser. This provision prevents "pyramiding" of Rule 506 offerings to some extent.

These examples demonstrate that, in most cases, the Adjusted Purchaser Count for a given Rule 506(b) offering will be less than the absolute number of persons who actually purchase securities in the offering. Further, because accredited investors are excluded from the Adjusted Purchaser Count under Rule 501(e), it is technically possible to have a Rule 506(b) offering that has an unlimited amount of accredited investors and zero purchasers.

Simultaneously, the Adjusted Purchaser Count cap of thirty-five imposes a limitation on nonaccredited investor participation.[86] This limitation on nonaccredited investor participation is furthered by the Adjusted Purchaser Count never resetting when nonaccredited investor participation decreases.[87] Even when, for example, a nonaccredited investor (i.e., a purchaser) redeems her interest in a Rule 506(b) offering, the Adjusted Purchaser Count remains unchanged. In other words, once a purchaser slot has been occupied by a nonaccredited investor, it can never be vacated.[88]

In sum, the operation of the Adjusted Purchaser Count permits accredited investors, clothed with the presumption they can sufficiently fend for themselves in the context of a Rule 506(b) offering, to participate in such offerings ad infinitum. Yet, restricting participation in Rule 506(b) offerings to only accredited investors would be tantamount to saying that some investment opportunities are only for specially situated persons or "the rich." This would cut against the notion Rule 506(b) offerings are worthwhile investments that more than a select few investors should have access to. The Adjusted Purchaser Count honors this latter notion, yet recognizes the risks of unlimited nonaccredited investor participation, by limiting the number of Rule 506(b) purchasers to thirty-five. At once, then, the Adjusted Purchaser Count is both protective and egalitarian.

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86 *See* 17 C.F.R. § 230.501(e) (2014); 17 C.F.R. § 230.506(b)(1) (2014). This should not be taken to mean the cap on nonaccredited investor participation is thirty-five. The other provisions of Rule 501(e) (namely, the exclusion of additional nonaccredited investors from the Adjusted Purchaser Count based on their relationship to another purchaser) theoretically permits greater participation by nonaccredited investors. However, that provision still has its limits. For a nonaccredited investor related to an existing purchaser to be excluded from the Adjusted Purchaser Count, that nonaccredited investor would need to reside at the *same primary residence* as the existing purchaser. *See* 17 C.F.R. § 230.501(e)(1)(i) (2014).

87 *See Compliance and Disclosure Interpretations: Securities Act Rules*, SEC.GOV, https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (last modified Jan. 23, 2015) (Question 260.04: "Once a company sells to 35 purchasers, as calculated pursuant to Rule 501(e), the company has reached the limitation on purchasers as set forth in Rule 506. The fact that a purchaser subsequently transfers or redeems her securities does not reset the number of purchasers or enable the company to sell to additional purchasers.").

88 *See id.*

ii. Raising the Bar, but Providing a Ramp: Sophistication as a Precondition, Purchaser's Representatives, and the Information Requirement

Nonaccredited investors participating in a Rule 506(b) offering must still be able to fend for themselves. However, since nonaccredited investors, by definition, are unable to fend for themselves by virtue of their wealth, income, or status, they must evidence that ability another way. Specifically:

> Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) *[must have] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment*, or the issuer [must] reasonably [believe] immediately prior to making any sale that such purchaser comes within this description.[89]

As alluded to above, and discussed at length in Part II, the "knowledge and experience" (also known as "sophistication") described in Rule 506(b)(2)(ii) is synonymous with the ability to fend for oneself.

Rule 506(b)(2)(ii) seems to erect before nonaccredited investors an additional barrier to entry just after the Adjusted Purchaser Count carves out for them a limited access exception. Nonaccredited investors must be able to evidence sufficient sophistication to evaluate the merits and risks of the prospective investment. However, the doors to a Rule 506(b) offering are not shut to those nonaccredited investors who do not themselves possess the necessary sophistication: they *may still* participate in a Rule 506(b) offering by using a "purchaser's representative."[90]

A purchaser's representative is defined in Rule 501(i) as a person who has the requisite knowledge and experience, either alone or together with other purchaser's representatives, to evaluate the merits and risks of the potential investment.[91] In effect, the purchaser's representative confers his or her sophistication on the nonaccredited investor by acting as a surrogate for the investor in evaluating the investment.

Rule 501(i) requires a purchaser's representative not be affiliated with the issuer (with certain specific exceptions).[92] Further, the purchaser must acknowledge his or her representative in writing.[93] Finally, the purchaser's representative must disclose to the purchaser in writing, at a reasonable time

89 17 C.F.R. § 230.506(b)(2)(ii) (2014) (emphasis added).

90 *Id.*

91 17 C.F.R. § 230.501(i)(2) (2014).

92 17 C.F.R. § 230.501(i)(1) (2014).

93 17 C.F.R. § 230.501(i)(3) (2014).

prior to the sale of the Rule 506(b) securities, any material relationship between the purchaser's representative or his affiliates and the issuer or its affiliates that (1) exists; (2) is "mutually understood to be contemplated"; or (3) has existed during the previous two years.[94] This disclosure must include a statement of any compensation received in connection with any relationship of that kind.[95] All of these requirements protect the interests of the unsophisticated, nonaccredited investor.

Taken in its totality, Rule 506(b)(2)(ii) again expresses the dual goals of protection and egalitarianism. On the one hand, the knowledge and experience requirement protects investors by limiting the universe of prospects: if you lack the requisite sophistication and you are not accredited, you may not invest. Standing alone, this exclusion would only heighten the perception that Rule 506(b) offerings are "special" and only available to certain "special" investors. More pointedly, accredited investors' blanket access to such offerings would only promote the inescapable conclusion these opportunities are the exclusive province of the specially situated or the rich. However, the purchaser's representative provision again presents an egalitarian path of access to these offerings for even the nonaccredited investor who lacks, on his or her own, the necessary sophistication.

The provisions of Regulation D and Rule 506(b) covered to this point generally further either one or both of the first two concerns identified at the outset of this subsection: investor protection and egalitarianism. The third goal, fairness, is expressed in a further provision: Rule 502(b), which is triggered when a nonaccredited investor is admitted to a Rule 506(b) offering.[96]

In a Rule 506(b) offering where only accredited investors participate, the issuer is not required to furnish those investors any information regarding the offering.[97] This is consonant with the ability to fend for oneself imputed to the accredited investor under Regulation D. The fundamental premise is that regulation ought not interfere in transactions between these "able" accredited investors and issuers. Yet, interference is the order of the day when nonaccredited investors are involved.

Leaving aside whether the presumption that investors accredited under the current standards (particularly those based on wealth or income) are "more able" than others is a cogent one, revisiting what theoretically makes an accredited investor accredited explains this differential treatment.

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94 17 C.F.R. § 230.501(i)(4) (2014)

95 *Id.*

96 17 C.F.R. § 230.502(b)(1) (2014); 17 C.F.R. § 230.506(b)(1) (2014).

97 *See* 17 C.F.R. § 230.502(b)(1) (2014).

Again, accredited investors are presumed able to fend for themselves due to their financial position and/or their status.[98] Typically, in the context of an investment transaction, greater financial resources or special status increases bargaining power. For example, an investor with greater financial resources may wish to make a substantial investment. Alternatively, even if such an investor makes a modest initial investment, that investor's participation represents the promise of additional follow-on investments, perhaps in larger amounts. Accordingly, the issuer will (or should) treat such an accredited investor at least as its equal in an earnest effort to consummate the transaction. The issuer will likely accede to requests for information made by the accredited investor.[99]

Pursuant to this logic, a nonaccredited investor, who is below the SEC-promulgated wealth and income thresholds and lacks special status, has less bargaining power than an accredited investor. Yet, these nonaccredited investors are expressly permitted to participate in Rule 506(b) offerings. Rule 502(b) steps in to eliminate any bargaining power disparities: it levels the playing field so that nonaccredited investors stand on the same turf as accredited investors and on equal footing with the issuer itself. Rule 502(b) does this by requiring issuers furnish the nonaccredited investor, at a "reasonable time prior to sale," information that can roughly be subdivided as follows: (1) nonfinancial information, (2) financial information, and (3) a description of any and all other information furnished to accredited investors.[100] This information is buttressed by the requirement that issuers make available to nonaccredited investors the opportunity to ask questions and receive answers regarding the offering.[101]

The nonfinancial information required by Rule 502(b) is generally the same kind of information an issuer would have to include in Part I of a registration statement filed under the 33 Act—in other words, what a registered offering would need to provide investors in its prospectus.[102] This information encompasses, among other things: the risk factors associated with the offering of securities; the offering's expected or actual use of proceeds; and an array of information about the issuer, such as a description of the issuer's business, its property, and any material legal proceedings the issuer has been, is, or may be subject to.[103]

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98 *See* 17 C.F.R. § 230.501(a)(1)-(8) (2014).

99 This line of reasoning seems to require an additional, preceding assumption: that the accredited investor would *know* what to ask the issuer (i.e., be sophisticated enough to fend for him- or herself). However, the accreditation categories that focus on wealth and income, in particular, tend to deemphasize this ability.

100 17 C.F.R. § 230.502(b)(2)(i)-(iv) (2014).

101 17 C.F.R. § 230.502(b)(2)(v) (2014).

102 *Compare* 17 C.F.R. § 230.502(b)(2) (2014), *with SEC Form S-1*, *supra* note 74.

103 *See SEC Form S-1*, *supra* note 74.

The financial information required by Rule 502(b) varies depending on the size of the offering. Under Rule 502(b), offerings are divided among three tiers: (1) those up to $2,000,000; (2) those up to $7,500,000; and (3) those over $7,500,000.[104] As discussed above, Rule 506 permits issuers to raise an unlimited amount of capital, which generally gives rise to offerings of indefinite size automatically falling into the third tier. Such an offering must provide to nonaccredited investors a financial statement certified by an independent public accountant, as would be required under the 33 Act.[105] Generally, procuring such a financial statement may be extremely costly, particularly in the context of a start-up. Rule 502(b) provides that an issuer who is not a limited partnership, and who cannot obtain a certified financial statement without unreasonable effort or expense, may furnish nonaccredited investors a balance sheet dated within 120 days of the start of the offering.[106] Limited partnerships who cannot obtain a certified financial statement without unreasonable effort or expense may furnish "financial statements that have been prepared on the basis of Federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant."[107] Additional information may need to be furnished if the issuer is subject to certain reporting requirements under the Securities Exchange Act of 1934.[108]

Finally, Rule 502(b) requires an issuer who has provided any "material written information concerning the offering" to any *accredited* investor to also provide a brief written description of that information to any potential nonaccredited investor at a reasonable time prior to a sale of securities.[109]

Facially, these requirements resemble something like "registration lite." Although the issuer is not required to submit any of these materials to the SEC or any state regulator, it is nevertheless true that, to comply with all the conditions of Rule 506(b) and the relevant general conditions of Regulation D, the issuer would have to take many of the same steps associated with registering under the 33 Act outright, such as providing written information in narrative and financial statement form. Recalling that all Rule 506 offerings are subject to the various antifraud provisions contained in the state and federal securities acts,[110] the prudent issuer

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104 17 C.F.R. § 230.502(b)(2)(i)(B)(1)-(3) (2014).

105 *See* 17 C.F.R. § 230.502(b)(2)(i)(B)(3) (2014); *see also Registration Under the Securities Act of 1933*, SEC.GOV, http://www.sec.gov/answers/regis33.htm (last modified Sept. 2, 2011).

106 17 C.F.R. § 230.502(b)(2)(i)(B)(3) (2014).

107 *Id.*

108 17 C.F.R. § 230.502(b)(2)(ii) (2014)

109 17 C.F.R. § 230.502(b)(2)(iv) (2014).

110 Meyer, *supra* note 22.

would, at minimum, also have to engage an experienced attorney and an experienced accountant to prepare the various required materials. This necessarily entails significant expenditures and could deter issuers from even considering admitting nonaccredited investors to a Rule 506(b) offering.

This result, without more, would seem to imply that the investor protection measures triggered by nonaccredited investor participation in a Rule 506(b) offering undermine what has been described as the egalitarianism of Rule 506(b)—that is, the ability for those who are not rich or specially situated to participate in the investment opportunities Rule 506(b) offerings represent. After all, if issuers will not offer to nonaccredited investors because doing so would impose too great a burden, nonaccredited investors are as estopped from participating in those offerings as they would be if there were an explicit ban on nonaccredited investor participation.

However, ending the analysis there would be somewhat facile. Though it is true that Rule 502(b) specifically sets forth the kinds of information an issuer *must* provide to nonaccredited investors, this does not mean that issuers do not regularly provide the same information to accredited investors who are considering investing. In point of fact, it is extremely likely issuers are *already* providing this information to those accredited investors. For one thing, the quintessential accredited investor, the "professional investor" (i.e., an institutional investor, such as a pension or mutual fund), has robust due diligence requirements, especially in today's marketplace.[111] A professional investor would at minimum require a private placement memorandum, which is industry standard. And the antifraud provisions *still apply* to these materials.[112] Accordingly, only a foolhardy issuer would elect not to retain an attorney to assist in the drafting of its memorandum. Viewed in this way, the "exorbitant costs" associated with admitting nonaccredited investors actually are not exorbitant at all. Instead, these costs are simply the standard costs of capital formation, for better or for worse.

Further encouraging issuers to comply with the terms of Rule 502(b) and offer their securities to nonaccredited investors is the simple reality that many issuers are initially funded by the friends and family of issuer "insiders." While some of these friends and family may be accredited, some may not be. That these investors can participate at the outset is sometimes critical to the offering even getting off the ground, and, as such,

111 *See, e.g.*, Alternative Inv. Mgmt. Ass'n, *AIMA Launches New Due Diligence Questionnaires*, AIMA.ORG (Apr. 12, 2007), http://www.aima.org/en/media/press-releases.cfm/id/51A9EFBE-E15D-4CEC-83A88A2376C6F333.

112 Meyer, *supra* note 22.

converts the protective and fair informational requirements from an untenable albatross to an acceptable cost of doing business.[113]

iii. Protection Through Limitation, Part II: The Prohibition Against General Solicitation

Triggered automatically by Rule 506(b), Rule 502(c) is the limitation on the manner of offering, the prohibition against general solicitation.[114] Rule 506(c)'s centerpiece is the elimination of this prohibition.[115]

Rule 502(c) is written fairly straightforwardly, though its gray-area implications have been legion. The provision prohibits an issuer offering securities under Rule 506(b), or any person acting on the issuer's behalf, from using "any form of general solicitation or general advertising" to offer or sell the Rule 506(b) securities.[116] Rule 502(b) provides illustrative examples of what kinds of general solicitation or general advertising are impermissible.[117] These include (1) "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio"; and (2) "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."[118]

Much has been said and written about how far the prohibition against general solicitation reaches and how ambiguous and arbitrary its reach is.[119] Of course, the illustrative examples furnish some bright-line rules: it is not permissible to advertise a Rule 506(b) offering in a newspaper. It is not permissible to broadcast a television advertisement for an investor seminar and then to solicit attendees to invest in a Rule 506(b) offering. But, as there usually is at the intersection of regulation and the practices of the regulated, there have been many, many cases at the margins.[120]

The SEC attempted to ameliorate some of the confusion by issuing a

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113 There is, of course, an argument that the information requirements, *in toto*, impermissibly impede capital formation, simply because they increase the costs of capital formation. However, this line of argumentation is tantamount to advocating the repeal of the antifraud provisions of the 33 Act. As I have shown, the kinds of information required by Rule 502(b) are the standard fare of professional accredited investors; those materials are subject to the antifraud provisions; and the specter of penalties under the antifraud provisions will typically compel an issuer to seek legal counsel and pay the requisite fees.

114 17 C.F.R. § 230.502(c) (2014).

115 *See generally* 17 C.F.R. § 230.506(c) (2014).

116 17 C.F.R. § 230.502(c) (2014).

117 17 C.F.R. § 230.502(c)(1)-(2) (2014).

118 *Id.*

119 *See, e.g.*, Seth Chertok, *A Theoretical Assessment of Private Placements Under Rule 506*, 8 N.Y.U. J. L. & BUS. 77 (2011).

120 *See id.* at 91-112.

series of no-action letters, which at one point seemed to suggest safety could be found in soliciting only individuals and entities with whom the issuer had a preexisting relationship.[121] More specifically, the safest kind of relationship appeared to be one that would permit the issuer "to be aware of the financial circumstances or sophistication" of the individual or entity.[122] But the SEC also said a preexisting relationship is but one factor in determining whether an offer violates Rule 502(c).[123]

Questions persisted. Was there a numerical limit to the amount of investors that could be solicited? Were there situations where investors with whom the issuer had no preexisting relationship could be solicited, particularly when they were known to be accredited and sophisticated? Even now, compliance with Rule 502(c) remains subject to case-by-case analysis.[124]

Barring all ambiguity, however, Rule 502(c)'s animating value is clear: before there can be any discussion of *who* can invest,[125] there is the practical question of *how many*. With general solicitation out-of-bounds, the answer to the latter question is *some number less than the entire investing public*. Importantly, the ban on general solicitation is *blind* to the accreditation status of investors—general solicitation to only accredited investors is as forbidden as general solicitation to nonaccredited investors. Accordingly, Rule 502(c) serves a single purpose: it limits the *absolute number of persons* who can be solicited to participate, *irrespective* of *who* those persons are.

This limitation on the manner of offering, and resulting limitation on the *universe of possible investors*, clearly and independently serves the goal of investor protection which is at the heart of all securities regulation. As discussed at the outset of this analysis, Rule 506(b) is an extremely powerful exemption; Rule 506(b) offerings are preemptively removed from the gaze of regulators. Too, Rule 506(b) offerings are comparatively riskier than most registered offerings, since neither Rule 506(b) nor Regulation D limits the "content" of such offerings or requires those offerings be vetted by any regulator before beginning. Finally, the procedural barrier to entry is low—really, at barest bones, merely a notice filing.[126] Accordingly, it is a hospitable exemption for start-ups, other unproven entities, and outright

121 *See, e.g.*, Mineral Lands Research & Mktg. Co., SEC No-Action Letter, 1985 WL 55694 (Dec. 4, 1985).

122 *Id.*

123 *Id.*

124 *See, e.g.*, Randall S. Dalton, SEC No-Action Letter, 1984 WL 45369 (June 22, 1984).

125 Which is handled by the accreditation provisions, the Adjusted Purchaser Count provisions, and Rule 506(b)(2)(ii).

126 17 C.F.R. § 230.503 (2014); *see supra* pp. 246-47.

fraudulent enterprises.

The prohibition against general solicitation is a "buffer," a counterbalancing measure to rein in and manage what could become a regulatory no-man's-land. Put simply, issuers advantaging themselves of Rule 506(b) can only reach a portion of the investing public. This narrows an issuer's prospects for capital raising, yes, but it also significantly limits the pool of potential victims should the issuer be ill intentioned (or merely negligently managed).

The prohibition is not arbitrary; it is logically consistent with section 4(a)(2) of the 33 Act, the authority for Rule 506(b). Section 4(a)(2) exempts from registration offerings of securities "not involving any public offering."[127] The opposite of "public" is "private." The plain meaning of "private" is "intended for or restricted to the use of a particular person, group, or class."[128] Though it is true that a safe harbor under section 4(a)(2), drafted with reference to the plain meaning definition of "private," would not necessarily proscribe general advertising, such a proscription would not be inconsistent with that plain meaning.[129]

Ultimately, Rule 502(c)'s practical imprecision remains its difficulty. However, there is something to be said about its longevity. Rule 502(c) remains integral to Rule 506(b) and also continues to apply to Rule 504 and Rule 505 of Regulation D.[130] It has served its purpose for over thirty years.

iv. The Goals of Rule 506(b)

Careful exploration of Rule 506(b) and the Regulation D provisions it implicates leads to concrete conclusions regarding what animates Rule 506(b).

One concern underlying the entire project, yet left chiefly as an unstated premise in this Rule 506(b)-specific analysis, is the encouragement and facilitation of capital formation. Without question, liberation from the hard and fast requirements of registration under the 33 Act *does* encourage and facilitate capital formation. Even though Rule 506(b) is not truly designed for issuers to set up shop one day, then begin offering securities

127 15 U.S.C. § 77d(a)(2) (2014).

128 *Private*, MERRIAM-WEBSTER DICTIONARY, http://www.merriam-webster.com/dictionary/private (last visited Apr. 5, 2014).

129 Concededly, the plain meaning of "private" could also be used to authorize a safe harbor under section 4(a)(2) that permits unlimited investment by accredited investors—investors of a *particular class*. This is precisely what Rule 506(c) is. However, as discussed in Part II, the definitive judicial interpretation of section 4(a)(2) did not merely adopt the plain meaning of "private." That judicial interpretation also did not prevent the SEC from adopting its original interpretation of "private," which involved the barring of all general solicitation. *See generally* SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

130 17 C.F.R. § 230.502(c) (2014); 17 C.F.R. § 230.504 (2014); 17 C.F.R. § 230.505 (2014).

another,[131] there is a considerable difference, in terms of expense, effort, and especially time, between preparing a private placement memorandum in consultation with a private attorney and drafting a prospectus which must be reviewed and approved by a securities administrator.

Three other concerns have been covered in this section: investor protection, egalitarianism, and fairness. These three concerns, taken together, explain the intricate interlocking of the provisions of Rule 506(b) and the relevant portions of Rule 501 and Rule 502. *Protection* is achieved by limiting not only the *kinds* (accredited and/or otherwise sophisticated investors), but the *number* of investors (no more than thirty-five nonaccredited, but sophisticated investors; only those investors the issuer can properly reach without violating the prohibition on general solicitation) who can access a given Rule 506(b) offering. *Egalitarianism* is furthered through the dual operation of the Adjusted Purchaser Count and the purchaser's representative provision, which allows not just the rich (as measured by wealth and income) or those specially situated (investors of a certain status) access to Rule 506(b) offerings. Finally, *fairness* is achieved by leveling the playing field among and between investors and the issuer by compelling the issuer to provide additional disclosure to those investors who are deemed to have lower bargaining power (nonaccredited investors).

That each provision supports and complements the others reveals this interlocking was carefully considered. Though commentators have criticized Rule 506(b) over the many years it has been in service,[132] and though it very clearly had and has its weaknesses, the balance it attempted to reach was and is admirable. Unfortunately, with the advent of Rule 506(c), that delicately crafted balance may have entered the final stretch to obsolescence.

3. Close Reading, Part II: Rule 506(c) and the New Regulatory Calculus

Rule 506(c) was added to Rule 506 effective September 23, 2013.[133] It was the first substantive revision to Rule 506 since its 1982 enactment. As discussed above, Rule 506(c) represented the SEC's compliance with the JOBS Act's mandate to remove the prohibition against solicitation associated with Rule 506.[134] Importantly, Rule 506(c) did not replace

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131 For they likely still need to assemble appropriate documentation to furnish to potential investors—accredited and nonaccredited alike.

132 *See, e.g.*, William K. Sjostrom Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1 (2004).

133 Rule 506(c) Adopting Release, *supra* note 1, at 44,772.

134 *Id.*

original Rule 506, which remains within Regulation D as Rule 506(b).[135]

The general terms and conditions applicable to Rule 506(b) apply with equal force to Rule 506(c)—the accredited investor concept, the principle of integration, the limitation on resale, and the much newer bad actor disqualification all obtain here.[136] However, Rule 506(c) marks a radical departure from Rule 506(b) in two major ways: (1) *only* accredited investors are permitted to participate in a Rule 506(c) offering,[137] and (2) the prohibition against general solicitation contained in Rule 502(c) does not apply.[138] Though these changes seem subtle, they represent a fundamental departure from the regulatory calculus that animates Rule 506(b).

Specifically, the changes either excise or significantly limit the expression of all the regulatory concerns—investor protection through limitation, egalitarianism, and fairness—that characterize Rule 506(b). Instead, Rule 506(c) embodies a political judgment, mediated through SEC rulemaking, that absolute expediency of capital formation in Rule 506 offerings is desirable and that such offerings are properly available only to the rich or the specially situated.

Simultaneously, Rule 506(c)'s protective mechanisms are hobbled, and not only through the abandonment of the prohibition against general solicitation. Significantly undermining the Rule's protective function are (1) lax controls on verifying the status of accredited investors, and (2) the continued absence of an enforcement mechanism that will vigilantly and proactively identify and halt offerings merely purporting to operate pursuant to Rule 506(c).

i. Only Accredited Investors

Only accredited investors may participate in a Rule 506(c) offering.[139] A novel addition to Rule 506(c) is that the issuer must take "reasonable steps" to verify each accredited investor's status.[140] However, echoing the much-reviled ambiguity of Rule 502(c), Rule 506(c)(2)(ii) provides only a number of "non-exclusive [sic] and non-mandatory methods" issuers may use to accomplish accreditation verification.[141] These methods include: (1) reviewing the investor's Internal Revenue Service forms for the immediately preceding two years (where accreditation is based on income);

135 17 C.F.R. § 230.506(b) (2014).

136 *See generally* 17 C.F.R. § 230.506(c), (d) (2014).

137 17 C.F.R. § 230.506(c)(2)(i) (2014).

138 *See generally* 17 C.F.R. § 230.506(c) (2014).

139 17 C.F.R. § 230.506(c)(2)(i) (2014).

140 17 C.F.R. § 230.506(c)(2)(ii) (2014).

141 *Id.*

(2) reviewing bank statements, brokerage statements, other statements, and consumer reports showing liabilities (where accreditation is based on net worth or net assets); and (3) obtaining a written confirmation from any of a registered broker-dealer, an investment adviser registered with the SEC, an attorney, or a certified public accountant confirming that party took reasonable steps to verify the investor's accreditation status within the preceding three months.[142]

Some commentators railed against the very suggestion that Rule 506(c) investors might be required to do anything other than self-certify their accreditation status.[143] The SEC acknowledged this backlash in Rule 506(c)'s Adopting Release, stressing that the methods of accreditation verification enumerated in the Rule are merely nonexclusive and non-mandatory and what constitutes an appropriate verification method in the context of a given offering will depend on the "facts and circumstances."[144]

Of course, the provision that only accredited investors may participate in a Rule 506(c) offering necessarily means absolutely no nonaccredited investors, irrespective of their sophistication, need apply.

ii. Lifting the Prohibition Against General Solicitation

Rule 502(c) does not apply to Rule 506(c) offerings.[145] Rule 506(c) provides no guidance as to what may or may not constitute an appropriate general solicitation. Facially, then, under Rule 506(c), any kind of general solicitation or general advertising goes.

On July 10, 2013, when Rule 506(c) was adopted, the SEC also proposed additional amendments to Regulation D.[146] One of the proposed amendments, which would create Rule 509, would require all Rule 506(c) issuers to include certain legends in any written general solicitation materials used in a Rule 506(c) offering.[147] Another proposed amendment would create Rule 510T, which would require issuers to submit to the SEC, on a temporary basis, any written general solicitation materials used in connection with a Rule 506(c) offering.[148] Under Rule 510T, written

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142 17 C.F.R. § 230.506(c)(2)(ii)(A)-(C) (2014).

143 Rule 506(c) Adopting Release, *supra* note 1, at 44,777, 44,777 n.75.

144 *Id.* at 44,777.

145 *See generally* 17 C.F.R. § 230.506(c) (2014).

146 *See generally* July 10, 2013, Proposing Release, *supra* note 42. In addition to the two proposed amendments discussed here, the July 10, 2013, Proposing Release also requested comments regarding the current accredited investor standards for natural persons contained in Rule 501(a). According to the July 10, 2013, Proposing Release, the SEC had begun a review of definition of accredited investors with respect to natural persons. However, as of the date of this writing, no further action has been taken. *See also infra* note 186.

147 July 10, 2013, Proposing Release, *supra* note 42, at 44,821-22.

148 *Id.* at 44,828-29.

general solicitation materials would need to be submitted to the SEC no later than the date of the first use of the materials in the offering.[149] As proposed, Rule 510T would expire two years from its effective date.[150]

Comments were solicited on the July 10, 2013, proposals; the comment period ended September 23, 2013, the date Rule 506(c) became effective.[151] On September 27, 2013, the comment period was reopened until November 4, 2013.[152] As of the date of this writing, no further action has been taken with respect to any of the amendments contemplated in the July 10, 2013, Proposing Release.

iii. A New, Fundamentally Different Regulatory Calculus

Rule 506(c) declares that whatever ameliorative effects the prohibition against general solicitation had, their absence is compensated for by the elimination of participation by nonaccredited investors, or those investors not presumed "able to fend for themselves." However, as discussed above, Rule 502(c) largely functions to constrain Rule 506's inherent power by limiting the universe of potential investors, *irrespective of whether they are accredited or not*. Restricting participation in Rule 506(c) offerings to only accredited investors does nothing to bridle Rule 506's potential for abuse.

Accordingly, Rule 506(c) cannot be considered an exercise in one-to-one cancelation, trading like for like. Instead, Rule 506(c) is best understood as embodying a new regulatory calculus, wholly different than the one animating Rule 506(b).

Key to understanding this new regulatory calculus is the recognition that nearly all the principles animating Rule 506(b) are no longer in play. Rule 506(b)'s unique method of furthering investor protection through limitation (on the manner of offering and the number of investors) is gone. Egalitarianism is absent here; if you are not accredited, you can have no part in the offering, irrespective of your personal knowledge and experience. Accordingly, the expression of fairness contained in Rule 506(b), particularly through the information requirements, is rendered obsolete.

Without the interplay of those three concerns, Rule 506(c) is merely an effective engine to amass capital, quickly and in large amounts, from investors who can successfully check a box on an accredited investor questionnaire. Its sole protective mechanism is an exclusive reliance on

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149 *Id.* at 44,828.

150 *Id.*

151 *Id.* at 44,806.

152 Amendments to Regulation D, Form D, and Rule 156; Re-opening of Comment Period, Securities Act Release No. 33-9458, Exchange Act Release No. 34-70538, 78 Fed. Reg. 61,222 (Sept. 27, 2013).

accredited investor standards that are, at minimum, presently doubtful.

The philosophical disjunction between Rule 506(b) and Rule 506(c) is apparent from the text. The practical and historical study of Rule 506(c) contained in Part II only independently confirms this disjunction.

II. STRESS POINTS: TWO PRACTICAL AND HISTORICAL STUDIES

Part I established, strictly through a close reading of the text, the philosophical disjunction between Rule 506(b) and Rule 506(c). It suggested that Rule 506(b) more intelligently serves the goals of securities regulation by striking a delicate balance between capital formation efficiency and the threefold aims of investor protection, egalitarianism, and fairness. Part II departs from the text to demonstrate that this philosophical disjunction is not exclusive to the text, but can be identified upon examination of the legal, regulatory, and legislative history of Rule 506(c) and the concepts it relies most heavily upon.

Specifically, Part II highlights two "stress points" contained within Rule 506(c). The first stress point is Rule 506(c)'s complete reliance on the accredited investor concept to achieve investor protection. Is this exclusive reliance (particularly in the context of accreditation through wealth and income) at all consistent with whatever historical legal and regulatory rationale preceded it? A review of the historical development of *what kinds of investors* Rule 506 and section 4(a)(2) offerings have been meant to serve answers that question in the negative.[153] Further, even if the accredited investor standards (particularly those based on wealth and income measures) were, *at some time in the past*, competent to identify investors qualified to participate in Rule 506 offerings, do those standards remain useful? Recent developments confirm they do not.[154]

The second stress point is the legislative narrative that led to Rule 506(c). The JOBS Act, including Title II, enjoyed widespread bipartisan support.[155] The rallying cry behind Title II, especially, was that the measure would help small businesses create jobs.[156] Yet, I contend Rule 506 was neither designed for, nor actually serves the interests of, small business. While it is true Rule 506 is used by all manner of issuers, a significant number are not even operating businesses, or "job creators," but private

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153 *See infra* pp. 268-70.

154 *See infra* pp. 271-73.

155 *See Roll Call Vote, On Passage of the Bill (H.R. 3606 as Amended)*, U.S. SENATE, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?&congress=112&session=2&vote=00055 (last visited Mar. 25, 2015); *Final Results for Roll Call 110*, HOUSE.GOV, http://clerk.house.gov/evs/2012/roll110.xml (last visited Mar. 25, 2015).

156 *See generally* 157 CONG. REC. H7289-95 (2011).

investment funds.[157] The more insidious contour is that, although many, many private investment funds have used Rule 506 responsibly, there are also many purported private investment funds that have used Rule 506 as nothing more than an eerily effective "vehicle for fraudulent transactions."[158] Unfortunately, Rule 506(c) may only enable fraudsters to reach a greater pool of victims.

A. Rule 506(c)'s Complete Reliance on the Accredited Investor Concept

Though Rule 506(c) and media accounts of Rule 506 generally might suggest otherwise, the accreditation standards do not, in and of themselves, represent the capacity to invest in a Rule 506 offering. Instead, the standards are a thirty-year-old SEC-created proxy[159] for the ability to fend for oneself, an investor quality that has been a necessary ingredient of offerings exempted from registration under section 4(a)(2) of the 33 Act since 1953.[160] Careful consideration of the historical development of the ability to fend for oneself raises questions of whether the accreditation standards (particularly those with wealth and income thresholds), standing alone, rationally signify an investor's ability to fend for him- or herself. Further, even if the accreditation standards, *at some time in the past*, accurately stood for an investor's ability to fend for him- or herself, it is doubtful those standards do so presently.

In *SEC v. Ralston Purina Co.*, the Supreme Court considered under what circumstances the section 4(a)(2) exemption from registration for "transactions not involving any public offering" under the 33 Act properly applied.[161] As the legislative history of section 4(a)(2) provided little guidance, the Court undertook a functional analysis of the provision.[162]

The Court considered section 4(a)(2)'s fundamental purpose.[163] As an exemption, it was enacted to relieve issuers who claimed it from complying with the registration provisions of the 33 Act, especially those provisions requiring issuers to make available information thought necessary to an

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157 *See* VLADIMIR IVANOV & SCOTT BAUGUESS, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, at 12 (2013), http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

158 Johnson, *supra* note 26, at 188.

159 Regulation D Adopting Release (1982), *supra* note 19, at 11,253-56.

160 *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953); *see also* Notice of Adoption of Rule 146 Under the Securities Act of 1933—"Transactions by an Issuer Deemed Not to Involve Any Public Offering," Securities Act Release No. 33-5487, 1974 WL 161966, at *2 (Apr. 23, 1974) [hereinafter Rule 146 Adopting Release].

161 *See generally Ralston Purina*, 346 U.S. 119 (1953).

162 *Id.* at 122.

163 *Id.* at 124-25.

informed investment decision.[164] The Court assumed that not all investors needed the protection flowing from registration. Specifically, the Court believed some investors were quite capable of obtaining the information registration would ordinarily disclose on their own.[165] The Court described these investors as those "who are shown to be able to *fend for themselves*."[166]

Importantly, the Court did not explain what precisely constitutes an investor's ability to fend for him- or herself. At most, it merely suggested at least *one factor* is whether the investor has access to, or can readily obtain, the kinds of information registration would compel disclosure of.[167] Ultimately, the Court held that when an offering is made only to investors who can "fend for themselves"—whatever that entails—the offering does not need the protections of the 33 Act, does not involve any public offering, and is properly within the scope of the section 4(a)(2) exemption.[168]

As aforementioned, the SEC eventually adopted the accredited investor standards as a proxy for the ability to fend for oneself articulated in *Ralston Purina*.[169] However, this adoption was neither immediate nor inevitable. This is demonstrated by the SEC's promulgation in 1974 of Rule 146, the precursor to Rule 506. Rule 146 developed the idea of the ability to fend for oneself without conditions resembling today's accredited investor standards.[170]

Rule 146, like Rule 506, functioned as a safe harbor under section 4(a)(2).[171] The SEC relied heavily on *Ralston Purina* in crafting this safe harbor: the availability of Rule 146 was conditioned on the nature of the offerees and specifically their ability to fend for themselves.[172] Picking up where the Court had left off, the SEC articulated what constitutes the ability to fend for oneself: "knowledge and experience in financial and business matters" such that the investor is capable of "evaluating the merits and risks of the prospective investment" (i.e., that the investor is "sophisticated").[173]

Significantly, *every* investor participating in a Rule 146 offering was

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164 *Id.*

165 *Id.* at 125.

166 *Id.* (emphasis added).

167 *Id.* at 125-27.

168 *Id.*

169 Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6339, 46 Fed. Reg. 41,791-01, at 41,802 (Aug. 7, 1981) [hereinafter Original Regulation D Proposing Release (1981)].

170 Rule 146 Adopting Release, *supra* note 160, at *18.

171 *Id.* at *3.

172 *Id.*

173 *Id.* at *18.

required to be sophisticated, either alone or with a purchaser's representative.[174] Though Rule 146 also required certain investors to have the "[ability] to bear the economic risk of the investment," that requirement kicked in only when an investor *was not sophisticated on his or her own* (that is, when an investor was required to use a purchaser's representative).[175] Accordingly, under Rule 146, investor sophistication was the principal signifier of an investor's ability to fend for him- or herself. The ability to bear economic risk, whether evidenced by wealth, income, or otherwise, was merely a contingent and additional safeguard.[176]

It is true that this nearly exclusive emphasis on investor sophistication did not persist in Regulation D and Rule 506. After all, Regulation D introduced the accredited investor concept. However, Regulation D's new investor qualification method was not divorced from its regulatory antecedents, including *Ralston Purina*. As to why unlimited accredited investors would be permitted to participate in Rule 506 offerings, the SEC explained:

> This approach is based on the presumption that accredited investors can fend for themselves without the protections afforded by registration . . . . The majority of commenters believed accredited investors . . . have the ability to fend for themselves in larger offerings contemplated under a Section 4(2) exemptive rule.[177]

Even thirty years on, this "presumption" rings at least slightly hollow, at least with respect to those accreditation standards that hinge on wealth and income. Nothing in *Ralston Purina* or Rule 146, the firmest legal authorities for section 4(a)(2) safe harbors prior to Rule 506, suggests economic resources, without more, sufficiently represent an investor's ability to fend for him- or herself. Measured solely against the historical development of the ability to fend for oneself, accreditation standards based on wealth and income have never been entirely rational.

Practically speaking, however, such a conclusion is based on too-narrow premises. At bottom, the accredited investor standards were adopted for convenience and efficiency. Issuers criticized Rule 146 because its investor qualification standards required subjective determinations.[178] Subjective determinations are time consuming and vulnerable to attack. The accredited investor concept provided issuers a

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174 *Id.*

175 *Id.*

176 Stated differently, the ability to bear economic risk protected the investor *even if* the sophistication proxy (the purchaser's representative) failed.

177 Original Regulation D Proposing Release (1981), *supra* note 169, at 41,802.

178 *Id.* at 41,793.

"greater degree of clarity."[179] Simply, the accredited investor definition essentially gave issuers a definite "qualification checklist," obviating free-floating judgments of investor sophistication (or, in certain cases, the ability to bear economic risk).

In the context of securities regulation, gains of efficiency are typically positive, but ought to be appropriately counterbalanced by investor protection *efficacy* and, ideally, other relevant principles, like egalitarianism and fairness. As discussed at length in Part I, original Rule 506 actually struck this balance. With respect to egalitarianism and fairness, original Rule 506's retention of investor sophistication as an alternative precondition only confirmed that the ability to fend for oneself is not solely a matter of wealth, income, or status.

Further, as to investor protection efficacy, it is plausible the accreditation standards, including those based on wealth and income, were a credible investor protection mechanism—*at the time those standards were originally promulgated*. As originally conceived, the accredited investor standards were intended to be a proxy for *both* sophistication (either an investor's own or through a purchaser's representative) and the ability to bear economic risk.[180] This required that any static wealth or income thresholds *actually* represented sophistication (or, at minimum, the means to obtain competent surrogate sophistication) and the ability to bear the loss of an investment in an exempted offering. A net worth of $1,000,000, or individual income of $200,000, quite possibly carried that burden in 1982.

The problem today is that the accreditation standards have been accorded primary importance in Rule 506(c)—yet the accreditation wealth and income thresholds *have essentially never changed*. Where in 1982 a net worth of $1,000,000 might have actually signified the ability to fend for oneself, the erosionary power of inflation has all but assured that is no longer the case. An investor with a net worth of $1,000,000 in 2014 is only 41% as wealthy as the same investor in 1982.[181] Similarly, an investor whose income is $200,000 in 2014 makes only 41% as much as the same investor in 1982.[182] It is simply not credible to assert an investor's accreditation status in 2014 means the same thing it did in 1982.

Long before the advent of Rule 506(c), under the original Rule 506

179 *Id.* at 41,795.

180 *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 405 (Dec. 27, 2006).

181 *CPI Inflation Calculator*, U.S. DEP'T. OF LAB., http://data.bls.gov/cgi-bin/cpicalc.pl (last visited Mar. 25, 2015); *see also* Greg Oguss, Note, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285 (2012).

182 *CPI Inflation Calculator*, *supra* note 181.

regime, the need to update the accreditation standards was clear. Particularly before the economic downturn, many middle-income investors (by today's standards) participated in Rule 506 offerings, accredited by virtue of their wealth or income, only to suffer paralyzing losses or be defrauded.[183] And this was with the added protection of the prohibition against general solicitation still in play.

In 2007, the SEC proposed revisions to the accredited investor standards, but ultimately withdrew them.[184] Only 2010's Dodd-Frank Act finally required the SEC review and modify, as appropriate, the accredited investor standards for the first time in July 2014 and then at least every four years thereafter.[185] Unfortunately, Rule 506(c) became effective in September 2013, and the SEC has taken no concrete steps since to update the accreditation standards.[186]

The internal weaknesses of the accreditation standards is an additional, significant reason why Rule 506(c)'s equivalence of "all accredited investors" for "unfettered general solicitation" is unconvincing. Though the continued operation of the prohibition would not have cured the defects in the accreditation standards, it would have at least served as an investor protection stopgap, hopefully long enough for updated accreditation standards to be promulgated. However, many natural persons currently accredited only with reference to the outdated wealth or income thresholds—and who are, accordingly, actually *not* able to fend for themselves—will be solicited to participate in Rule 506(c) offerings.

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183 *See, e.g.*, Amy McCullough, *They Thought They Were Protected*, MISS. BUS. J. (Oct. 12, 2009); *see also supra* note 25.

184 *See generally* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, Investment Company Act Release No. IC-27922, 72 Fed. Reg. 45,116 (Aug. 3, 2007).

185 July 10, 2013, Proposing Release, *supra* note 42, at 44,829.

186 *See* Rule 506(c) Adopting Release, *supra* note 1, at 44,772. In October 2014, the SEC's Investor Advisory Committee recommended the accredited investor standards be updated; its specific suggestions and observations are consistent with many contained in this Comment. *See* SEC INVESTOR ADVISORY COMM., RECOMMENDATION OF THE INVESTMENT ADVISORY COMMITTEE: ACCREDITED INVESTOR DEFINITION (2014), https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.

However, it is doubtful the accreditation standards will be updated in the immediate future, in large part due to internal disagreement. Not long after the Investor Advisory Committee issued its recommendation, one SEC Commissioner characterized interest in updating the accreditation standards as an "obsession with 'protecting' millionaires . . . potentially at the cost of hindering the wildly successful and critically important private markets . . . [it] strains logic and reason . . . . Millionaires can fend for themselves." *See* Mark Schoeff Jr., *SEC's Daniel Gallagher Questions Need to Revise Accredited-Investor Standard*, INVESTMENTNEWS (Nov. 20, 2014, 1:39 PM), http://www.investmentnews.com/article/20141120/FREE/141129994/secs-daniel-gallagher-questions-need-to-revise-accredited-investor. It is unclear whether this Commissioner has reviewed the data regarding the wealth erosion wrought by inflation over the past thirty years or has spoken to any of the individuals whose life savings have been wiped out by fraudulent Rule 506 offerings. *See supra* note 25.

What is particularly poignant here is that the JOBS Act required Rule 506(c) to be promulgated within ninety days from April 5, 2012.[187] Though it was not promulgated until well over a year later, the congressional directive evidenced a distinct and troubling urgency. The legislators who enacted the JOBS Act knew the accreditation standards Rule 506(c) would exclusively rely on were no longer viable, as confirmed by the Dodd-Frank Act passed less than two years before. Yet, they pushed for the promulgation of the Rule well ahead of the date any adjusted accredited investor thresholds would take effect.

Additionally, Congress's urgency at least in part suggests Rule 506(c) was not as carefully considered as it could have or should have been. As a basis for comparison, original Regulation D was proposed in August 1981, three years after a month of preliminary hearings and an extensive review of the then-existing exemptive scheme.[188] Regulation D was not promulgated for a further seven months, for a life cycle totaling nearly four years.[189] That time was apparently well spent; as discussed at length in Part I, Regulation D and original Rule 506 evidence careful consideration and thoughtful drafting. Though neither Regulation D nor Rule 506 as originally enacted was without fault, they nevertheless consistently served the obvious goal of investor protection and also substantially furthered other principles, like egalitarianism and fairness.

Rule 506(c) does not seem nearly as well conceived. Its centerpiece is a faulty investor protection mechanism: outdated investor qualification measures now removed from their legal and regulatory antecedents. Unlike original Rule 506, where efficiency and investor protection efficacy were pursued in equal measure, Rule 506(c) appears to seek only absolute expediency of capital formation.

B. Title II's Congressional Narrative

The congressional urgency in enacting Title II and interest in the speedy promulgation of Rule 506(c) touches on the second stress point identified at the beginning of this Part. I contend Congress deployed a faulty narrative in seeking and ultimately passing Title II. Specifically, the congressional record is awash with characterizations of Title II as a measure that will "help small businesses" start up and grow, and, ultimately, "create jobs."[190] However, Rule 506 is an outsized method for providing start-up

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187 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313-14 (2012).

188 *See* Original Regulation D Proposing Release (1981), *supra* note 169, at 41,792.

189 *See* Regulation D Adopting Release (1982), *supra* note 19.

190 *See generally* 157 CONG. REC. H7289-95 (2011).

capital to what we typically refer to as a "small business"; other exemptions under Regulation D appear better suited to that task. Additionally, a significant number of Rule 506 issuers are not "job creators" at all, but private investment funds.[191]

What eventually became Title II of the JOBS Act was first introduced in the House of Representatives in late 2011 as H.R. 2940.[192] The bill's lead sponsor, Congressman Kevin McCarthy, opened debate on the bill by recounting the story of the deli he started when he was twenty.[193] At some point after his business became fairly successful, he wanted to open new stores in his town.[194] However, he said the bank had turned him down for a loan, and "because of the regulations by the Federal Government," he could only talk to people with whom he had a preexisting relationship.[195] Because he "didn't know people with money," he would have had to consult with an attorney, "file with the SEC," and do "things that [he] did not have time to do as a small business."[196] By Congressman McCarthy's account, his dream of a chain of delis evaporated in large part due to the federal securities laws.

The Congressman's story would be compelling if the bill he proposed, and which ultimately became Title II, was responsive to his trials as a younger man and small business owner. First, H.R. 2940 specifically targeted Rule 506, which permits issuers to raise an *unlimited amount of capital*.[197] That his bill targeted Rule 506 implies, to some extent, that he wished to avail himself of Rule 506 all those years ago. However, the need to raise an unlimited amount of capital intuitively cuts against the apparent needs of small business, especially business start-ups. Glibly, how much did setting up a deli, or even five delis, cost during 1987 in California? Was it really more than today's equivalent of $1,041,971.83—the amount Mr. McCarthy could have raised if he had availed himself of Rule 504 under Regulation D?[198] Though, yes, Rule 504 would have required him to consult an attorney and register with his *state* securities administrator (not the SEC), it would have allowed him to generally advertise his offering

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191 *See* IVANOV & BAUGUESS, *supra* note 157, at 12.

192 H.R. REP. NO. 112-263 (2011).

193 157 CONG. REC. H7290 (2011) (statement of Rep. Kevin McCarthy).

194 *Id.*

195 *Id.*

196 *Id.*

197 17 C.F.R. § 230.506 (2014).

198 1987's $500,000 is equivalent to $1,041,971.83 in 2014. *CPI Inflation Calculator*, U.S. DEP'T. OF LAB., *supra* note 181. In 1987, Rule 504's offering size limit was $500,000; the rule was later amended to increase that limit to $1,000,000. *See* Regulation D Revisions, Securities Act Release No. 33-6758, 53 Fed. Reg. 7,866 (Mar. 3, 1988).

throughout not only his community, but his *entire state*[199]—which, based on his narrative, is all he wanted.

Second, again, H.R. 2940 targeted the prohibition against general solicitation with respect to Rule 506 only—not Rule 504 or Rule 505, the exemptions under Regulation D which would intuitively appeal to small businesses, not to mention the exemptions which might prove more manageable to regulate. State regulation of Rule 504 and Rule 505 is not preempted by NSMIA, which allows state securities administrators to more diligently protect investors from rogue offerings thereunder. Rule 504 and Rule 505 offerings are currently capped at $1,000,000 and $5,000,000, respectively.[200] Without question, a $1,000,000 or $5,000,000 offering is far smaller than an offering of "indefinite size," but these smaller offerings are completely consistent with the needs of small businesses as defined by the government. For instance, the *maximum* loan amount a small business can secure from the Small Business Administration is $5,000,000, and the *average* loan size in fiscal year 2012 was $337,730, a fraction of Rule 504's offering size limit *in 1987*.[201]

Admittedly, all of this is at least arguable. In the financial environment of the past several years, anything billed as economic succor is looked at favorably. It may have been divisive or impossible to propose the imposition of a "cap" on the growth potential of small business. (Although this begs the question why Rule 504 and Rule 505 remain on the books at all.)[202]

Still, there remains one issue that no congressperson touting H.R. 2940 addressed: the degree to which *private investment funds* use Rule 506. Private investment funds, by definition,[203] do not "raise capital *to create and maintain jobs, to invest in research and development, to sell and*

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199 Regulation D Adopting Release (1982), *supra* note 19, at 11,257-58.

200 17 C.F.R. §§ 230.504-.505 (2014).

201 Regulation D Adopting Release (1982), *supra* note 19; *7(a) Loan Amounts, Fees & Interest Rates*, SBA.GOV, http://www.sba.gov/content/7a-loan-amounts-fees-interest-rates (last visited Apr. 6, 2014). 2014's $337,730 is equivalent to $162,062.92 in 1987—in other words, *32%* of Rule 504's $500,000 offering size limit in 1987. *CPI Inflation Calculator*, *supra* note 181.

202 Especially in light of data that indicates the overwhelming majority (to the tune of 99%) of Form D filers claim Rule 506, not Rule 504 or Rule 505. *See* IVANOV & BAUGUESS, *supra* note 157, at 3. As Ivanov and Bauguess conclude, this likely indicates issuers value Rule 506's preemption of state law. *Id.* But the flight to Rule 506 because of Rule 504's and Rule 505's deficits only again begs the question of why Congress chose to "modernize" Rule 506, not Rule 504 or Rule 505.

203 Private investment funds are most easily understood as private investment *companies*—entities that would be required to register as investment companies under the Investment Company Act of 1940 but for a definitional exclusion. The SEC defines an investment company as an entity "that issues securities and is *primarily engaged in the business of investing in securities*." *Investment Companies*, SEC.GOV, http://www.sec.gov/answers/mfinvco.htm (last modified July 9, 2013) (emphasis added).

market goods and services . . . ."[204] They raise capital to *invest in securities*. While private investment funds may *indirectly* stimulate job creation through investment, they are not primary job creators. Yet the data shows such funds regularly rely on Rule 506 to offer their securities.[205] In fact, between 2009 and 2012, private investment funds raised nearly $3 trillion through Rule 506 offerings; nonfund issuers raised only 22% as much during the same period.[206]

Rule 506(c) permits private investment funds, new and old, to directly compete with Rule 506(c) operating companies for new investors. Given the mythical status hedge funds and private equity funds (and their managers) have in the public consciousness,[207] is it reasonable to believe persons generally solicited to invest in either a start-up company or an "elite" private fund will actually invest in the former over the latter?

Nevertheless, it is true many operating companies use Rule 506.[208] Title II may spur increased small-business capital formation; perhaps more small businesses will find Rule 506 more accessible, now that the prohibition against general solicitation has been lifted. However, it is equally plausible that the real driver behind Title II was distantly related to bona fide small business. The private fund lobby actively sought the passage of H.R. 2940.[209]

Part I of this Comment spoke of egalitarianism. Although that egalitarianism manifested itself in the form of access to investment opportunities on the part of investors, it can and should apply with equal force to issuers, too. To the extent Rule 506(c) runs the risk of squeezing out bona fide small business for much larger market forces, it runs counter to the stated mission of Title II of the JOBS Act.[210]

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204 157 CONG. REC. H7292 (2011) (emphasis added) (statement of Rep. Robert Dold).

205 *See* IVANOV & BAUGUESS, *supra* note 157, at 12.

206 *Id.* at 11. It is true that the nature of private investment funds and their investors contributes significantly to the great amount of money such funds raised; classically, private investment funds pool large capital contributions together for the purpose of investment. *See supra* note 203. Operating businesses do not have the same capital needs and will almost always raise less. Still, because it is the *norm* for private investment funds to use Rule 506 to amass large amounts of capital, those fraudulent private investment funds who have exploited Rule 506 have claimed enormous amounts of victims' money. *See, e.g.*, *SEC Charges Feeders to Petters Ponzi Scheme*, SEC.GOV (Nov. 9, 2011), http://www.sec.gov/news/press/2011/2011-237.htm.

207 *See, e.g.*, Steve Fishman, *Hedge Fund Managers Get Richest Quickest*, N.Y. MAG. (Nov. 22, 2004), http://nymag.com/nymetro/news/bizfinance/finance/features/10426; Randall Smith, *Goldman Gurus Strike It Rich with Hedge Fund*, WALL ST. J. (Apr. 20, 2006, 12:01 AM), http://online.wsj.com/news/articles/SB114550097877130828. *But see, e.g.*, *Investing: Rich Managers, Poor Clients*, THE ECONOMIST (Dec. 22, 2012), http://www.economist.com/news/leaders/21568740-investors-have-paid-too-much-hedge-fund-expertise-better-focus-low-costs-star.

208 *See* IVANOV & BAUGUESS, *supra* note 157, at 12.

209 Peter Schweizer, *Politicians' Extortion Racket*, N.Y. TIMES, Oct. 22, 2013, at A23.

210 *See generally* 157 CONG. REC. H7289-95 (2011).

III. CONCLUSION

I designed this Comment to take the reader on the same journey I embarked on when I began my research: from believing the lifting of the prohibition on general solicitation was merely an imprudent modification of current law to viewing it as symptomatic of a paradigm shift, a fundamentally different regulatory philosophy and calculus. A close reading of Rule 506(b) and Rule 506(c), as well as careful study of the stress points discussed in Part II, demonstrate the disjunction between the new regulatory calculus animating Rule 506(c) and the exemptive model that presaged it.

In the introduction to this Comment, I mentioned I first intended this to be an indictment of the lifting of the prohibition against general solicitation. I ultimately did not write an "indictment." More precisely, though this Comment is full of criticism for Rule 506(c), it stops short of calling for its repeal. That said, there are measures that can and should be taken to ensure the new Rule serves the fundamental investor protection goals that all securities regulation is meant to further. The weaknesses of Rule 506(c) are susceptible to remediation through action across a number of specific areas. I conclude by specifically enumerating three such areas.

First, the amendments contained in the SEC's July 10, 2013, Proposing Release.[211] While those amendments remain in limbo, the SEC should proceed with all haste to issue final rules. The protections contemplated by those further amendments could make the difference between a workable and unworkable Rule 506(c).

Second, the accredited investor wealth and income thresholds must be adjusted as soon as possible, and the SEC should attend to proposals that suggest the wealth and income thresholds should either be supplemented or replaced by a liquid investments requirement.[212]

And, finally, something that has been expressed subtly throughout this Comment: reconsideration of the scope of NSMIA's preemption of state law with respect to Rule 506 to promote investor protection. State securities administrators have long advocated for the end of the preemption.[213] I would not advocate states be given plenary power over Rule 506 offerings. However, state securities administrators should be

211 *See supra* pp. 265-66. *See generally* July 10, 2013, Proposing Release, *supra* note 42.

212 *Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered*, U.S. GOV'T ACCOUNTABILITY OFFICE (July 18, 2013), http://www.gao.gov/products/GAO-13-640.

213 *See, e.g.*, First Public Hearing of the Financial Crisis Inquiry Commission 4-6 (Jan. 14, 2010) (Testimony of Denise Voigt Crawford, Comm'r, Texas Securities Board, and President, North American Securities Administrators Association, Inc.), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0114-Transcript.pdf.

empowered to *proactively* investigate, enforce, and halt illicit activity. They are well positioned to do this, to share the burden, especially since the SEC's enforcement record with respect to Regulation D has been mixed.[214]

If appropriate time and attention are allocated to these three areas, it is eminently possible that the new Rule 506 can overcome its shortcomings and become a worthy successor to its parent, a regulation that served our capital markets so faithfully for so long.

214 *See generally* SEC OFFICE OF THE INSPECTOR GEN., OFFICE OF AUDITS, REGULATION D EXEMPTION (2009), http://www.sec.gov/about/offices/oig/reports/audits/2009/459.pdf.