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The Regulation D Two Step: Facebook, Goldman Sachs, and the Effect on Private Investment Funds

By Cory White[1]

Facebook and Goldman Sachs

In January of 2011 Facebook completed a private raise of money that totaled $1.5 billion dollars as a result of direct investments by Goldman Sachs and indirect investments from high-net-worth (accredited) Goldman clients. The raise was a result of two separate private placements that, because of the type of securities offered and the timing of the offerings, would have been integrated into one offering under SEC rules.[2] Integration causes what would otherwise be considered separate private placements to be treated as one private placement. The first private placement occurred in December of 2010 and netted Facebook $500 million, with $450 million coming directly from Goldman and $50 million coming directly from Russian investment firm Digital Sky.[3] The second private placement occurred in January of 2011 and netted Facebook another $1 billion, coming directly from a Goldman investment fund (the "Goldman Fund") populated by the investments of non-US investors.[4]

The second placement raises some interesting questions, questions about public disclosures during private placements as well as about how far US securities laws can reach when investors in a transaction are non-US investors.[5] This article does not seek to answer those questions, but seeks to answer another that applies to all private investment funds. For the purpose of the discussion, let's assume a private fund engages in a similar transaction to that of the Goldman Fund but this transaction involves US parties on all sides, making it unequivocally subject to US securities laws. If this were the case, what type of securities liability exposure would the private fund and/or the portfolio company (i.e. Facebook) face for misrepresentations or omissions made by such portfolio company during the securities transaction? As always, we start by following the money-- how does money legally enter a private fund and how does it legally leave.

Regulation D's 506

Unless exempt, securities cannot be offered or sold without registration under Section 5 of the Securities Act of 1933.[6] Sometimes the securities themselves are exempt but, more often-than-not, the issuer needs to seek an exemption for the transaction itself. If securities are privately

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[2] 17 C.F.R. § 230.502(a).
[3] "Goldman Offering Clients a Chance to Invest in Facebook," Susan Craig and Andrew Ross Sorkin, New York Times, January 2, 2011 available at http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/.
[4] "Facebook Raises $1 Billion from Investors Outside the US," Associated Press available at http://wraltechwire.com/business/tech_wire/news/blogpost/8985765/.
[5] See "Private Placements of Securities: A London View of the Facebook Saga," Sean Geraghty and Christopher G. Karras, available at lexology.com (noting that the European Union's securities laws were potentially more attractive to Goldman Sachs).
[6] 17 U.S.C. § 77e.

placed, i.e. issued to a select number of investors with proper disclosures, an issuer does not have to register the offering with the SEC or state securities regulators. What constitutes a "private placement" is a long story populated by case law and administrative decisions, but the SEC provides each issuer with cliffnotes through the Regulation D safe harbor.[7] A large private investment fund, such as the Goldman Fund, would seek to utilize Rule 506 of the Regulation. That Rule allows for the issuer to amass an unlimited amount of money from up to 35 purchasers as long as the purchasers are accredited or sophisticated.[8] "Accredited purchasers" do not count toward the 35 purchaser limit. What constitutes an "accredited purchaser" and the merits of that definition is a discussion for another day.

Money coming into a private investment fund would be the result of investors making a privately placed investment into the fund, and the money going out would be the result of the fund making a privately placed investment into the portfolio company. In each instance, the entity receiving the money and issuing monetary interests or shares is considered the issuer. Rule 506 would be used to facilitate both sides of the transaction. It should be noted that private placements can occur under Rules 504 and 505, sometimes with less stringent disclosure requirements, but there is a limit of $5 million on the amount of money that can be raised at any one time from such transactions.[9]

Liability-Who is on the Hook to Investors?

One of the simplest truths about securities law and regulation in the United States is that an exemption from registration does not exempt an issuer from the anti-fraud provisions of the law. Privately placed transactions are still subject to all the anti-fraud provisions of the Securities Act of 33 and the Exchange Act of 34. Perhaps the most famous anti-fraud provision is Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[10] If an issuer intentionally makes a material omission or misrepresentation in connection with the purchase or sale of a security it could potentially lead to liability.[11] In this regard a private fund could potentially be liable to its investors for any intentional omissions or misrepresentations during its offering process. But what if a portfolio company of the private fund makes an intentional omission or misrepresentation to the private fund causing the fund to lose value? The portfolio company may certainly be liable to the private fund, but could the portfolio company be liable to the fund's investors? Would the fund itself be liable to its investors? Unless the fund was somehow found to have aided and abetted the portfolio company, it would not be liable to its investors under Section 10(b).[12] As to whether or not the investors can go after the portfolio company, it depends.

[7] 17 C.F.R. §§ 230.501-508.
[8] 17 C.F.R. § 230.506.
[9] 17 C.F.R. §§ 230.504-505.
[10] 15 U.S.C. § 78j.
[11] 17 C.F.R. § 240.10b-5.
[12] 15 U.S.C. § 78t(e) (allowing the SEC to pursue aider and abettor liability); see also SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996).

While there are several factors needed for a prima facie showing of securities fraud, the answer to the portfolio company's liability to the private fund's investors turns on whether or not the portfolio company's fraud was "in connection with" the sale of the private fund's securities to its investors. Under the often cited *SEC v. Texas Gulf Sulphur*, unless the fraudulent statements or omissions are calculated to influence and reach the investors in question the "in connection with" requirement would not be met.[13] The US Supreme Court in *SEC v. Zandford* noted that "in connection with" is satisfied if the fraud in question properly coincides with the sale of securities.[14] If fraudulent statements or omissions from the portfolio company are never transmitted to the fund's investors or are transmitted after the investors have already invested in the fund, the fund's investors will not have a cause of action against the portfolio company under Section 10(b). Still, if the fraudulent statements or omissions of the portfolio company were used by the fund in formulating fund's offering prospectus to investors, there may be a cause of action against the portfolio company for both the fund and its investors.[15]

The Take Away

Private funds should always do extensive due diligence prior to investing in any portfolio company as part of a two tiered transaction, similar to the Facebook-Goldman Sachs transaction. If there is reason to believe something is afoot, proceed with caution and ask for more information before entering into any transaction with the company. Even when not acting fraudulently, Section 12 of the 33 Act applies to negligent behavior in misrepresenting certain information to investors. As evident by the Facebook-Goldman Sachs transaction earlier this year, the stakes are high. The consequences of an omission or misrepresentation can be just as high.

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[13] SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2nd Cir. 1968); see also SEC v. C. Jones & Co. 312 F. Supp. 2d 1375 (D. Colo. 2004).

[14] SEC v. Zandford, 535 U.S. 813 (2002)

[15] See also SEC v. Zandford, 535 U.S. 813 (2002) (noting that if securities are sold as part of an overall fraudulent transaction there is enough to establish the in connection with prong of the prima facie case).