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SPECIAL FEATURE

Pornography and Common Law Private Placements

By Stephen M. Honig

What do "common law private placements" of corporate equity and pornography have in common? No one can define either, but people spend endless hours attempting to describe their characteristics.

Recent events have highlighted the confusion surrounding making a lawful private placement outside of the regulatory safe harbors of Rule 144A and Regulation D, although there continues to be a vigorous market for such transactions.

Here, we refer to non-safe-harbor placements as common law private placements.

First, the American Bar Association's Business Law Section issued a report attempting to define the current law on making common law private placements (see "The Business Lawyer," November 2010).

In January, Goldman Sachs proposed an investment vehicle to effect a large equity investment by numerous people on Facebook, similar to arrangements proposed for Twitter, both "non-public" companies. The commentary surrounding Goldman's use of a single purpose entity to aggregate multiple investments centered around avoidance of '34 Act registration. It also should have focused on the possible unavailability of an exemption from '33 Act registration by reason of packaging large numbers of investors into a single entity. Practitioners regularly deal with the law and lore of common law private placements in everyday corporate life.

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A defective dialogue

It doesn't seem likely that regulatory clarity will be forthcoming any day soon. During the PLI's early February program, "The SEC Speaks," Meredith Cross, director of the division of corporate finance, was asked if the SEC contemplated regulatory action to clarify common law private placements based on the ABA report. The question came at the end of a day during which the Commission staff spent hours listing all the rulemaking and investigatory efforts imposed on an underfinanced SEC by Dodd Frank, so Cross' response was not unexpected.

"Right now we simply don't have the bandwidth to do that," she said.

The problem with the debate about what a good common law private placement looks like is that the people talking about it are focused on how to maneuver the existing mix of component elements into the clearest articulation of ground rules that will achieve compliance.

The defect of this dialogue is that it fails to address what a rational, zero-base budgeted common law rule should look like. Further, by definition, you cannot create an ideal "common law" rule by governmental decree because it then ceases to be common law.

But since creation of an ideal rule for common law private placements actually requires a total revision of the SEC regulatory attitude towards all placements imposed by government action that preempts both existing regulations and present unclear common law practices, it turns out that we need to wholly abandon the dual system of safe harbors versus common law private placements.

Why consider such a proposition when the SEC has declared it lacks the bandwidth to address the topic at all? Only by starting to discuss basic concepts will we ever develop a consensus that will shape true reform when the time finally arrives. Now that the SEC has the ability to, in effect, waive the archaic 1933 Act provisions by exemptive action or no action letter, we can hope someday to achieve a rational system for effecting all private placements, trumping the statute itself through administrative exemption in a manner that cannot be achieved by statute consistent rulemaking.

Ideal rules for private placements

The ABA report correctly concludes that there is little difference between complying with the SEC safe harbors for private placements and complying with today's common law (non-safe-harbor) exemptions. This is because although the primary regulatory exemptions from necessity to register in compliance with Section 5 of the '33 Act, as embodied in Regulation D and Rule 144A, are articulated as "nonexclusive" exemptions, these SEC safe harbors themselves were derived in reliance on prior common law practice.

Thereafter, these safe harbors have been used circuitously as reference points by courts in determining whether a private placement outside of the regulatory safe harbor nonetheless meets the Section 4(2) exemptive standard.

Let us focus on a non-institutional equity offering. Whether there is an exemption from registration under both Regulation D and the current "common law" of private placements depends on many of the same factors: Is the buyer wealthy and possessing sufficient business acumen so that it does not need regulatory protection; in what manner is the offering made so as to avoid a wide solicitation to unsophisticated investors; is adequate information given or at least accessible to the investor; and is there some limit on resale of the securities? Preventing a resale avoids creating a "distribution" which by definition would make the investor an "underwriter" under Section 2(11) of the '33 Act, and thus destroy the exemption from registration.

In imagining an ideal regulatory system, the nuances between the Regulation D safe harbor and present common law private placements are not easy to understand and should be rendered irrelevant in favor of a single standard. One that is not a non-exclusive safe harbor, but rather, constitutes a universal exemption under Section 4(2), decreed by the SEC, with preemption of inconsistent state law.

The following transactions should be exempted from registration, with fraud being controlled at the back end through enforcement of federal and state anti-fraud statutes:

"Relational" nonpublic companies, whether they are start-ups, small businesses or mature companies. A company can issue any amount of equity to family, friends and pre-existing business contacts. Resales should be permitted at any time within the group qualifying as initial purchasers.

Non-relational start-ups, nonpublic mature companies, or public companies not reporting under the '34 Act. To the extent an investor is without "relationship" and is not institutional, a company can issue any amount of equity to anyone possessing defined business sophistication, including investors located through broker-dealers or unregistered finders, even if the finders fulfill what is today considered technically to be BD functions. Any investors without requisite business sophistication must either be advised by an expert or receive a placement memorandum akin to the kinds of materials typically used today in the marketplace. Financial capacity should be irrelevant. Resales free of restriction should be permitted in all events to investors with similar sophistication, while other resales should be permitted after six months.

Public companies reporting under the '34 Act. Private placements versus public offerings is an obsolete distinction for these entities. For reporting companies, we should embrace continuous unified disclosure as functional for all purposes. A company up-to-date in '34 Act reporting and without possession of appropriately withheld material information should be able to issue freely tradable equity at any time, without regard to the company's size or profitability and granted the freedom to restrict transferability of its shares (or not) by contract if it so elects for its own corporate, non-regulatory purposes.

Sales to institutional investors: These sales remain fundamentally exempt from registration concerns, as is the case under current Rule 144A.

Why deregulate?

We need to foster formation of capital. Increased regulation has failed to prevent fraud or negligence in offerings. What is the defense against fraud? Persons with relationships with people forming or operating businesses must rely on those relationships. Persons without relationships must rely on their own acumen or lack of it, subject to back-end statutory protections against fraud.

Capital is on an unrelenting drive towards fluidity worldwide: It now is free to move to markets when rapid exits and prompt liquidity are available.

Retail investors have been said to have substantially abandoned the U.S. equity markets for a variety of reasons: the recent economic "meltdown," numerous frauds undetected by SEC oversight, and lack of clarity in the returns to be obtained by playing the market. This is a salutary development to be embraced and built upon.

In a world of growing complexity, success in investment requires intelligence and training. Having a regulatory scheme for private placements designed to protect the everyday retail investor is outdated and will continue to impede capital formation. We already see capital flowing to non-U.S. markets, the creation of secondary trading markets for unregistered shares, and ever-growing SEC regulation and disclosure which nonetheless do not forestall market losses that arise from increasingly volatile technological changes or simple outright fraud.

We need a new model. Unlike pornography or compliant common law private placements, we can indeed define it. We just need to stop rearranging the old playing pieces and reinvent the game board.

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