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COMPANY REGISTRATION AND THE PRIVATE PLACEMENT EXEMPTION

Merritt B. Fox[†]

INTRODUCTION

Over the last twenty years, there has been a steady shift in securities disclosure regulation away from its traditional transactional basis toward a system of company registration.[1] Under the transaction

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[1] This shift began with the SEC's adoption in the early 1980s of rule 415 and S-3 short form registration. Rule 415, 17 C.F.R. § 230.415 (2000), permits the registration of securities that any issuer intends to "put on the shelf" rather than sell immediately. Securities Act Release No. 6499, 48 Fed. Reg. 52,889 (1983). Rule 415 is a departure from the traditional position of the SEC not to permit an issuer to register securities that it does not intend to sell immediately. The position was based on an interpretation of the language of § 6(a) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77f(a) (1994), and reflected a policy against the sale of securities on the basis of stale information. *See* Shawnee Chiles Syndicate, 10 S.E.C. 109, 113-14 (1941).

The S-3 short form registration procedure takes advantage of the fact that under the periodic reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §§ 78a-78kk (1994), a registered issuer must annually file a form 10-K, which covers a wide range of questions about the issuer's business, finances, and management, a quarterly report on form 10-Q and, when certain "extraordinary events" happen, a "current report" on form 8-K. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,382-85 (1982). The S-3 form allows an established, thickly traded issuer to incorporate by reference into its registration statement the information provided in the 10-K, 10-Q, and 8-K filings. The only information relating to the affairs of the issuer that must actually be set out in the registration statement is, in most cases, the use of proceeds and a description of any material change since the last 10-K not already described in a subsequent 10-Q or 8-K.

In the first half of the 1990s, the SEC took steps that further reduced the central role that the registration statement and prospectus traditionally played in regulating the offering process, loosening the rules on pre-filing publicity and pre-effectiveness written promotions. *See* John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1150-55 (1995). In 1996, the SEC's Advisory Committee on the Capital Formation and Regulatory Process (the "Advisory Committee"), chaired by then Commissioner Steven Wallman, issued a report exploring what a full-fledged company registration system would look like and recommending a voluntary pilot program. *See* Report of the Advisory Committee on the Capital Formation and Regulatory Processes, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834 (1996) [hereinafter Wallman Report]. In response the SEC released, in November 1998, its "Aircraft Carrier" proposal. *See* The Regula-

based approach, each new public offering of a security has to be registered under the Securities Act of 1933 (the "1933 Act"), a requirement that reflects the SEC's traditional concern that the most important time to have high-quality disclosure is at the moment of a securities offering. Under the company registration approach, an established, publicly traded issuer would register just once, provide information thereafter on a periodic basis, and then be able to offer and sell securities whenever it wishes, without the need to register the securities themselves.[2] The logic of the shift to company registration rests on two pillars. One is the fact that pursuant to the periodic reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act"), publicly traded issuers are already required on a continuing basis to answer most of the questions that they have been traditionally been asked to answer when they registered new offerings of securities under the 1933 Act.[3] The other is the efficient market hypothesis, which holds that all information contained in an established issuer's periodic reports is immediately reflected in the trading price of the issuer's securities. Registration of new offerings, the logic suggests, serves no useful purpose since it simply involves repetition of information already reflected in the issuer's secondary market share price, which in turn will set the price of the new offering.[4]

The shift to company registration is not yet complete, and, while the momentum for it continues, a number of questions remain to be resolved.[5] This Article addresses one of the most important and con-

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tion of Securities Offerings, Exchange Act Release No. 33-7606A, 63 Fed. Reg. 67,174 (1998). While not fully abandoning the traditional transactional basis of disclosure regulation, the proposal moved, for a group of established publicly traded issuers, further in the direction of company registration by putting increased emphasis on 1934 Act periodic disclosure and by reducing restrictions on communications by firms contemplating or engaging in an offering and eliminating SEC review of offering registrations. The SEC stopped pushing the proposal in early 1999, after aspects of it were widely criticized. *See* Rachel Witmer, *Registration: SEC Staff Presses Ahead to Update Regulation of Securities Offerings*, 32 Sec. Reg. & L. Rep. (BNA) 1549 (2000). However, reportedly, it is pursuing parts of the proposal separately. *See* Sarah O'Brien, *Latest Proposal Seeks to Overcome Wall Street Opposition: SEC Wants Curtain Lifted on IPO Roadshows*, INVESTMENT NEWS, Feb. 5, 2001, at 19; Neil Roland, *New SEC Chairman Likely to Face Pressure from Wall Street*, DALLAS MORNING NEWS, Dec. 29, 2000, at 11D.

[2] The origins of the concept are a 1966 article by Milton Cohen. *See* Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1341-42 (1966). It subsequently formed the organizing principle behind the American Law Institute's proposed codification of federal securities law. *See* FEDERAL SECURITIES CODE (1980).

[3] *See supra* note 1.

[4] For a discussion of the logic of company registration in the context of the first big steps in that direction, rule 415 shelf registration and short form registration, see Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984); Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005 (1984).

[5] *See* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567 (1997); Coffee, *supra* note 1; Donald C. Langevoort, *Deconstructing*

tentious of these unresolved questions: Should the private placement exemption be retained for issuers that are part of the company registration system, and, if so, what should the exemption look like?[6]

At first glance, this question appears to attack a non-problem: What possible need is there for an exemption for transactions involving the private offering of securities when company registration would remove the need to register securities offerings in the first place? A moment's reflection, however, suggests that the question does not disappear so easily. Assume, as will almost certainly be the case, that an issuer in the company registration system faces a higher level of civil liability when a violation of the system's disclosure regulations is accompanied by a *public* sale of securities than when it is accompanied by *no* sale of securities. We need to decide whether the issuer should also face this higher level of civil liability when the violation is accompanied by a *private* sale of securities. The question poses a dilemma. On the one hand, one of the attractions of company registration is that it permits the elimination of the distinction between private and public sales, which would save the large amount of legal resources currently devoted to determining and policing the border between the two. On the other hand, if the distinction is maintained, the parties to a private sale may be able to design what is for them a more effective or less costly contractual liability regime than is provided by the one-size-fits-all liability regime that is applied to public transactions.

Since the question of whether a company registration system should include a private placement exemption arises primarily because of the answer's implications for civil liability, it cannot be properly addressed without considering the larger issue of what civil liability in a company registration system should look like more generally. Thus, this Article starts with a discussion of what society can hope to accomplish with a company registration based system of mandatory disclosure and the role of civil liability in promoting these goals. These observations are then applied to the private placement exemption question. I conclude that there is a place for the private placement exemption within a company registration system.

Section 11: Public Offering Liability in a Continuous Disclosure Environment, LAW & CONTEMP. PROBS., Summer 2000, at 45.

[6] *See* Wallman Report, *supra* note 1, at 88,424-25 (arguing the advantages of issuers adopting a system with no exemption); *id.* app. B at 41-45 (same), *id.* app. A at 38-45 (noting the difficulty in maintaining distinctions among public, private, and offshore offerings); Coffee, *supra* note 1, at 1177-85 (recommending retention of the exemption).

I. THE NEED FOR EQUALLY STRONG REGULATORY COMPLIANCE INCENTIVES WHETHER OR NOT THE ISSUER IS SELLING SECURITIES

From an efficiency point of view, the primary function of civil liability for securities disclosure regulation violations is to provide corporate decision-makers with incentives to comply. I conclude that it is desirable for these decision-makers to have equally strong incentives to comply whether the issuer is selling securities or not. My reasons, detailed below, are two-fold. First, the real social benefits of issuer disclosure are equally great whether or not the issuer is selling securities. Second, given this, it is desirable that issuer choices between internal and external finance and among sources of outside finance be based on the real economic costs and benefits involved and not be distorted by considerations of civil liability.

A. *The Social Benefits of Disclosure*

The primary social benefit of issuer disclosure is *not* investor protection. Rather, the benefits are the improved selection of new investment projects in the economy, the improved operation of existing projects and the reduction in capital market illiquidity. These benefits arise equally whether an issuer is selling securities or not.

1. Investor Protection

Issuer disclosure is not necessary to protect investors against either unfair prices or risk, the two goals of investor protection.[7] Under the efficient market hypothesis, securities prices are *unbiased* whether there is a great deal of or very little information available about an issuer. Greater disclosure is thus not necessary to protect investors from buying their shares at prices that are, on average, unfair, that is, greater than their actual value. Issuer disclosure does reduce risk, but the only kind of risk that it reduces is *unsystematic* risk. Simply by being diversified, investors can protect themselves from this unsystematic risk much more effectively and at a lower societal cost than through government-mandated increases in issuer disclosure.

2. Improving Selection of New Investment Projects and the Operation of Existing Ones

Disclosure enhances efficiency by improving the *selection* of proposed new investment projects in the economy and the *operation* of existing projects. These improvements arise both through disclosure's beneficial effects on the legal mechanisms for assuring quality

[7] I have considered the points discussed here in significantly more detail elsewhere. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532-44 (1997).

of corporate governance and on existing market mechanisms that help align managerial interests with those of shareholders and that help determine each firm's cost of capital.

a. Legal Mechanisms[8]

Disclosure strengthens the effective exercise of shareholder franchise because a better informed shareholder is more likely to vote for the directors who in fact are most likely to maximize share value and for the share value maximizing choices in regards to all other matters subject to shareholder vote. Disclosure also enhances effective derivative suit enforcement of management's fiduciary duties because managers are unlikely to provide information voluntarily concerning their breaches of these duties. Additionally, it makes corporate law provisions requiring special procedures in connection with the authorization of transactions in which management has an interest more meaningful by making the existence of such conflicts more easily detected.

b. Market Mechanisms

Disclosure has beneficial effects on the operation of three of the economy's key market based mechanisms for controlling managerial behavior: the market for corporate control, share-price based managerial compensation, and capital allocation.

Disclosure strengthens the effectiveness of the market for corporate control. This increases the threat of a hostile takeover when managers act in a non-share-value-maximizing way. A potential acquirer must make an inherently risky assessment of what a target would be worth in its hands. Greater disclosure reduces the riskiness of this assessment. Because the potential acquirer's management is risk averse, this reduction means that a smaller apparent deviation between incumbent management decision-making and what would maximize share value is then needed to impel the potential acquirer into action.

Disclosure strengthens the usefulness of share-price based compensation as a way of motivating management by inducing management to accept a larger portion of its total compensation in share-price based form. The problem for managers with share-price based compensation, compared to straight salary with the same expected value, is the undiversifiable unsystematic risk it imposes on the manager. More disclosure makes share prices more accurate, which reduces this unsystematic risk.

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[8] I also consider these points elsewhere in more detail. *See* Merritt B. Fox, *Required Disclosure and Corporate Governance*, LAW & CONTEMP. PROBS., Summer 1999, at 113, 116-20.

Disclosure, by improving share-price accuracy, also improves the allocation of scarce capital among the proposed real investment projects in the economy. This is because an issuer's share price will affect a firm's decision whether to undertake a proposed investment project. A more accurate share price increases the likelihood that a good project will be implemented and a bad one not. This is obvious when a firm does not have sufficient internal funds to finance a project and a public sale of equity represents the least cost method of external finance. It is true in other circumstances as well, however. There is evidence that share price affects the terms demanded by other available external sources of funds.[9] It also affects management's willingness to use internal funds to implement a new project.[10]

3. Increasing Liquidity

Insiders and their tippees can make supranormal profits by engaging in trades in the secondary market based on non-public information. Market makers and specialists cover the expected costs of being on the other side of such trades through their "bid/ask" spread. The bigger the spread, the more illiquid the issuer's shares, the less valuable they are to hold, the lower the price at which the issuer can sell them in the primary market, and hence the greater is the issuer's cost of capital. By reducing the amount of non-public information and hence the opportunities for insiders and tippees to engage in such trades, disclosure reduces bid/ask spreads and increases liquidity.

4. Conclusions Concerning Disclosure Benefits

This overview shows that, in large measure, *issuer disclosure has equal social value whether or not the firm is selling equity at the time.* This showing has two important implications. First, it provides a normative affirmation for the core logic for the shift to company registration. The core logic is that established issuers are already required on a continuing basis to answer most of the questions that they have traditionally been asked to answer when they registered new offerings and that no useful purpose is served in requiring them to be answered again at the time of each securities offering since, according to the efficient market hypothesis, they are already reflected in price. The showing of equal social value demonstrates that it is fully appropriate that under company registration the issuer is required to disclose no more when it is issuing securities than at other times.

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[9] *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 123 (1979) (discussing the effects of share price on borrowing power).

[10] *See* MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 282-87 (1987).

The second implication of the equal social value showing is that the system of civil liability should be structured in a way that corporate decision-makers have equally strong incentives for disclosure regulation compliance whether or not the firm is selling equity at the time. With this goal in mind, however, it is important to take account of the fact that when a firm is making a public sale of equity, corporate decision-makers have extra motives for defying these regulations not otherwise at work. This is because suppression of negative required information will permit securities to be sold at higher price. Thus, on top of its ordinary incentives for compliance, the civil liability system must, at the time of equity sales, provide an antidote for this extra motive.

B. Avoiding Distortions in the Choice Among Financing Sources

Efficiency requires that management choices between internal and external finance and among sources of external finance should reflect the social costs and benefits of these choices. Because the social value of an issuer's disclosure is equally great regardless of what source of finance an issuer uses, a system that imposes a greater expected civil liability for a disclosure violation (net of any private gains from the violation) when managers choose one kind of financing rather than another introduces an inefficient distortion.

The current liability system in the United States, which was developed as part of the traditional transactions based system of disclosure regulation, violates the principle that the civil liability system should not introduce such distortions. It imposes significantly heightened risk of liability on *managers and others* if a violation occurs at the time the issuer is publicly offering new securities that, unlike *issuer* liability, is not counterbalanced by greater gains from the violation.[11] This discourages domestic public equity offerings relative to other sources of investment funds.

More specifically, a number of losses arise from such a distortion. To the extent that it leads to a use of internal funds, it favors a source of finance that permits management to shield its real investment decisions from the discipline and scrutiny of the market. This is a problem because managers may find it in their personal interests to enhance firm size and growth by implementing as many projects as possible even when the projects have an implementing negative net

[11] *See infra* Part II.C.

present value.[12] There is substantial empirical evidence that managers of firms which rely predominantly on internal finance do just that.[13]

To the extent that the distortion leads to greater use of non-public external finance, such as private placements of securities, 144A offerings, and Regulation S offerings, there are social costs as well. Securities sold pursuant to these vehicles have reduced liquidity due to resale restrictions necessary to prevent the vehicles from being used as conduits to unregulated public offerings. Reduced liquidity makes the securities less valuable to their purchasers and so the proceeds received by firms from such sales are discounted accordingly. Greater use of non-public external finance also results in more legal and administrative resources devoted to determining whether a particular method of raising funds avoids a domestic public offering—and is hence exempt from registration—as well as to when and how the investors buying the securities can resell them.

II. THE PROPER DESIGN OF A COMPANY DISCLOSURE CIVIL LIABILITY SYSTEM

Starting from the principle that the system of civil liability should be structured in a way that corporate decision-makers have equally strong incentives for disclosure regulation compliance whether or not the firm is publicly offering its equity, how should that system by structured?

A. Substantive Rules Governing Disclosure

The core concept behind company registration is that each issuer is required to provide periodic disclosure—yearly, quarterly, and special additional filings for extraordinary events—and that this would form the main base of mandated disclosure to inform the primary as well as secondary markets in its stock. In addition, it is probably necessary, however, that any time an issuer offers to sell more than a de minimis amount of additional equity (more, perhaps than a few percent of its shares in any three month period), it must disclose any material changes since the last periodic report. Otherwise, issuers will have an incentive to offer securities immediately after they be-

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[12] *See* FOX, *supra* note 10, at 121-27; FRANK KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) (discussing the agency costs resulting from managers using internal financing to engage in unnecessary expansion).

[13] *See, e.g.*, GORDON DONALDSON, CORPORATE DEBT CAPACITY (1961); William J. Baumol et al., *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STAT. 345 (1970). For a critical review of these and several other studies, along with an estimate of the magnitude of the effects on the economy, see FOX, *supra* note 10, at 233-37. *See also* Jensen, *supra* note 12, at 325; Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 898 (1988) (discussing the discounts created by misinvestment of surplus cash flows).

come aware of bad news and prior to the time that they would be required to disclose it in their periodic reports.

Assuming that the level of disclosure sought on an ongoing basis is comparable to the level of disclosure traditionally provided in an underwritten, registered public offering, the annual reports, and perhaps the quarterly ones as well, should be signed not only by top executives and a majority of directors, but also by some kind of a legally certifying, financially sound entity capable of rigorous due diligence, such as an investment bank. In return for the liability risk and the costs of due diligence, the certifying entity would charge a fee.

B. Issuer Liability

1. A Disclosure Violation with No Offer of Securities

Unlike the present system, an issuer should not be liable for civil damages if it commits a disclosure violation but offers no securities.[14] This is because disclosure's primary social function is to improve corporate governance and lower issuers' cost of capital by reducing illiquidity. Thus, in the first instance, the corporation is the party hurt by the violation, just as it is by a director or officer's breach of a fiduciary duty. Derivatively, the persons ultimately damaged by the violation are thus the current shareholders of the corporation. It is not the persons who purchased or sold at unfavorable price during period of violation. These buyers and sellers in the secondary market, in terms of the price they pay, are no better off on an expected basis with a disclosure regulation complying corporation than with a non-complying one because the overall effect of disclosure violation on investors trading in secondary market is a zero-sum game. Each winner and loser is in that position by reason of chance and is just as likely to be in the opposite position as the result of disclosure violations by other issuers.

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[14] Under 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1994), and rule 10b-5, 17 C.F.R. § 240.10b-5 (2000), issuers not trading in their own securities *are* civilly liable for damages caused by a materially false or misleading statement if a plaintiff can show the statement was made with scienter. Potential rule 10b-5 liability for 1934 Act disclosure violations by firms that do not trade in their own securities did not develop, however, until the late 1960s. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 857-62 (2d Cir. 1968) ("We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith . . . ."). This potential liability, in turn, did not become a serious threat to most issuers until class actions became possible with the development of the fraud on the market theory of reliance, which was first enunciated in the lower courts in the 1970s and was affirmed by the United States Supreme Court only in 1988. *See* Basic Inc. v. Levinson, 485 U.S. 224, 241-47 (1988).

2. *An Offer of Securities when a Disclosure Violation Exists*

The issuer's public offer of securities at the time a disclosure violation exists should, like under current law, make the issuer absolutely liable.[15] The amount of liability should be equal to the increase in the sale price resulting from the violation, returning what would otherwise be special gain for issuing securities when a disclosure violation inflates price.[16] Thus it is not an incentive to provide higher than usual compliance at the time of such sale, rather it is an antidote for what would otherwise be an incentive to provide lower than usual compliance. The benefit of such liability should run to the person or persons who purchased each offered security during the period that the market price is affected by the disclosure violation.

C. *Liability of Other Actors*

A disclosure violation should trigger imposition of liability on the directors, officers, and certifying investment bankers *whether or not a sale of securities occurs*. The liability would be absolute, subject to a due diligence defense, which is the current rule when the issuer is offering securities[17] but not otherwise.[18] The amount of each individual defendant's liability should be limited by a formula related to the issuer's annual capital expenditures and to each defendant's normal liability in a traditional 1933 Act contribution action. It should be payable to the *issuer* since it is the issuer that is hurt by the violation.[19]

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[15] Absolute issuer liability is currently imposed under § 11(a) of the 1933 Act, 15 U.S.C. § 77k(a).

[16] The current measure of damages under 1933 Act § 11(e), 15 U.S.C. § 77k(e), provides plaintiffs with an approximation of this amount. In ordinary cases, the plaintiff's prima facie case for damages is established by showing the difference between the price paid and the value at the time suit is brought, which would be the price at a point after the truth has come out. The defendant is allowed an affirmative defense to reduce these damages to extent that it can show that the decline in value was due to other causes.

[17] *See* 15 U.S.C. §§ 77k(a), 77k(b).

[18] In theory, even when the issuer is not offering securities, if the plaintiff can meet the much higher standard of showing scienter, particular officers and directors of the issuer could potentially be liable under rule 10b-5 as the person or persons who actually made the false or misleading statement or, where the issuer is liable, as controlling persons under 1934 Act § 20(a), 15 U.S.C. § 77t(a). In practice, however, officers and directors get sued less frequently than the issuer. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 699. *See also* Langevoort, *supra* note 5, at 54 (arguing that refocusing liability on individual managers rather than the corporate issuer might dissuade managers from committing securities fraud). Moreover, they almost never pay any of the eventual settlement of the suit. *See id.* at 54-55 (noting that private class action securities fraud suits are typically settled with more than 99% of the funding coming from the issuer itself and its insurance policies).

[19] In the case where the disclosure violation is *not* accompanied.by a sale of securities, the sole harm from the violation is damage to the effectiveness of the mechanisms that promote good corporate governance of the issuer and the increase in the illiquidity of the issuer's shares. *See supra* Part II.B.1. In the case where the disclosure violation *is* accompanied by a sale of

The object of placing liability on non-issuer actors in the limited amounts suggested is to give directors, officers, and, most importantly, the certifying entity, the same civil liability incentives to make the issuer comply with its periodic disclosure requirements as they traditionally had to make the issuer comply with the 1933 Act registration statement requirements when it engaged in a public offering of securities.

III. THE PRIVATE PLACEMENT EXEMPTION

A. The Contending Positions

Some full-fledged proposals for company registration impose the same liability system on all sales of securities, whether private or public. This, for example, appears to have been the position of a majority of the members of the SEC's Advisory Committee, chaired by former Commissioner Steven Wallman.[20] The Advisory Committee's report suggests several benefits that would arise from the abolition of the private placement exemption. These include elimination of the legally complex distinction between private and public offerings and some of the accompanying concepts such as integration and gun-jumping,[21] the elimination of restrictions on resales by affiliates and statutory underwriters that were developed to prevent evasion of the registration rules by an initial private sale followed by the purchaser engaging in a public offering,[22] the claimed "merging" of private and public markets for securities,[23] and the problems with Regulation S foreign offerings of shares traded in the United States being evasions of the registration provisions.[24]

Professor Coffee, on the other hand, argues for retention of the private placement exemption.[25] He has two rationales. First, an issuer may be in possession of material non-public information not re-

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securities, the issuer can at the same time gain from the violation if the violation inflates the price at which the securities are sold. Issuer liability, however, corrects for this gain. *See supra* Part II.B.2.

[20] *See supra* note 1. The Wallman Report suggested a number of benefits from eliminating the exemption. *See* Wallman Report, *supra* note 1, at 88,409. Also, Professor Coffee has stated that eliminating the exemption was the preferred position of some members of the Advisory Committee. *See* Coffee, *supra* note 1, at 1180. The Advisory Committee, however, decided that in its proposed pilot program, each issuer accepting the SEC's invitation to join a company registration system should have, at the time it joins, the option of having a private placement exemption or not. It gave as its reason a concern that "at this initial stage and until issuers become comfortable with the company registration concept, the loss of the ability to conduct exempt private placement and offshore offerings could be a deterrent to the voluntary use of the company registration system." Wallman Report, *supra* note 1, at 88,424.

[21] *See* Wallman Report, *supra* note 1, at 88,424.

[22] *See id.*

[23] *See id.* app. A at 38.

[24] *See id.* app. A at 43-45.

[25] *See* Coffee, *supra* note 1, at 1180.

quired to be disclosed absent a sale. It may be contrary to the issuer's interest to disclose the information publicly but the issuer can trust a private buyer to keep the information confidential.[26] Second, institutional purchasers in such private transactions will, if they are forced to hold on to securities for a period before reselling to public, perform a due diligence role that substitutes for the due diligence done by underwriters in a public offering. Coffee believes this is especially valuable because he fears that public offering underwriter due diligence, already less effective than it has traditionally been,[27] will be further weakened in its effectiveness by the smaller size of likely deals under company registration ("just-in-time capital") and the speed with which deals can be done.[28]

B. Applying the Framework to the Problem

Assume, as I propose and as would be the case under the Advisory Committee's proposal, an issuer in the company registration system faces a higher level of civil liability when a violation of the system's disclosure regulations is accompanied by a public sale of securities than when it is accompanied by no sale of securities. The question of whether to have a private placement exemption is whether the issuer should also face this higher level of civil liability when the violation is accompanied by a private sale of securities. The analysis above of the larger issue of what civil liability in a company registration system should look like more generally, with its focus on the social value of disclosure and the desirability to avoid distortion of choices among sources of finance, thus forms a useful framework as well for analyzing the desirability of a private placement exemption.

1. The Social Value of Disclosure

Consider first the discussion of the social value of disclosure. It was established there that public disclosure is equally valuable whether or not the issuer is selling equity at the time. Therefore, as long as the legal regime governing issuer disclosure is adequate for periods when the issuer is not selling its securities, it should, subject to the qualifications set out below, be adequate as well at the time that the issuer is selling securities.

The liability system proposed above imposes sanctions on *non-issuer* actors that should be sufficient to guarantee the quality of public disclosure at times when the issuer is not selling securities. The

[26] *See id.*

[27] Underwriter due diligence was significantly weakened by the short form and shelf registration programs initiated in the early 1980s. *See* Fox, *supra* note 4, at 1025-32; *supra* note 1. *See also* Langevoort, *supra* note 5, at 65-68 (suggesting alternatives to the SEC's current rules providing for underwriter liability in short form registrations).

[28] *See* Coffee, *supra* note 1, at 1182-85.

only recommended modifications to this regime in the case of a *public* sale of securities is the filing of updating information and the imposition of absolute liability on the issuer for any inflation in price due to a disclosure violation. The rationale for requiring updating disclosure is to prevent a special incentive for sales during the period between the issuer becoming aware of bad news and when it must disclose the news in a periodic filing. The rationale for imposing liability on the *issuer* is to serve as an antidote for the extra incentive not to comply with disclosure regulations at time of offering.

a. Large Institutional Purchasers

A consideration of these rationales for the modifications in the regime when public sales of securities are conducted shows that the modifications are not needed in the case of private sales to one or a few large institutional purchasers. In other words, a private placement exemption is appropriate in the case of such a sale. The key concern should be the ability of the buyer or buyers to fully counteract the special incentive that the issuer has to make sales during the period between the issuer becoming aware of bad news and when it must disclose the news in a periodic filing[29] and the special incentive that the issuer has not to comply with disclosure regulations in filings made in anticipation of the offering.[30] A large institutional buyer in a private transaction, assuming it is not allowed to turn around and sell to anyone but a comparable institution before the passage of sufficient time that any undisclosed material information is likely to become public, should have both the competence and the motivation to negotiate a private due diligence process and a contractual liability scheme that would satisfy these concerns. The motivation comes from the fact the private party will suffer the loss if it falters in effectively counteracting the issuer's special incentives: It will buy at a price inflated by not reflecting the non-disclosed negative information, but will sell at a price that does reflect this negative information. Indeed, in terms of meeting the concerns that generate the recommended modifications to the periodic disclosure regime when a public offering occurs, the privately negotiated solution reached by the issuer and the private purchasers, because it is tailored to the situation that these particular parties face, may well be less costly or more effective than the one-size-fits-all regime imposed on public offers.[31]

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[29] *See supra* Part II.A.

[30] *See supra* Parts I.A.4, II.B.2.

[31] The contractual regime might impose absolute liability, for example, but use a different standard of materiality or a different measure of damages.

b. Other Private Purchasers

How should other kinds of transactions that today qualify for the private placement exemption be treated? These.exemptions are available where the transaction has certain characteristics: the aggregate size of the offering is small, the number of people to whom the offering is made is small, and/or the purchasers are wealthy, sophisticated, or well advised. The primary origin of these exemptions is Regulation D under the 1933 Act, which provides three principal safe harbors based on various combinations of these characteristics.[32]

In the traditional transaction based system of securities disclosure regulation, each of these exemptions can be justified, in varying proportion, by two rationales. One is that it is not cost-effective to provide the level of disclosure required by the traditional registration process where the offering is small in aggregate size or involves relatively few purchasers. The other rationale is that purchasers who are sufficiently sophisticated, knowledgeable, or well advised do not need the information produced by the registration process in order to make intelligent investment decisions. Neither of these rationales, however, has much applicability in a world of company registration with a civil liability scheme of the kind proposed above. In such a world, high quality information is being provided to the market on an ongoing basis anyway without the offering registration process.[33]

The inquiry of whether these exemptions should be available in a company registration world must therefore focus on the question of whether in such a world it would be appropriate to exempt an issuer from the liability scheme applied to public sales when it engages in the kinds of sales that the exemptions currently cover. The same analysis that suggests it *is* appropriate to exempt the issuer in the case of a purchase by one or a few large institutional investors suggests it

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[32] Regulation D consists of 1933 Act rules 501-508, 17 C.F.R. §§ 230.501-.508 (2000). Rule 501 establishes the concept of an "accredited investor," which includes not only financial institutions and charitable institutions with more than $5 million in assets, but also directors and executive officers of the issuer and individuals with more the $1 million in wealth or $200,000 in annual income. *See id.* § 230.501. Under rule 504, an issuer may, without registration, sell to any number of purchasers, accredited or otherwise, up to $1 million of securities in any 12-month period. *See id.* § 230.504. Under rule 505, an issuer may, without registration, sell to any number of accredited purchasers and up to 35 unaccredited investors (who must be given information) up to $5 million of securities in any 12-month period. *See id.* § 230.505. Under rule 506, an issuer may, without registration, sell to any number of accredited purchasers and up to 35 unaccredited investors (who must be given information, must either have knowledge or experience in financial and business affairs or be advised by such a person, and for whom the securities must be suitable) an *unlimited* amount of securities. *See id.* § 230.506.

[33] In the proposal above, the only change in disclosure that would be occasioned by a sale of securities is the requirement that the issuer disclose any material changes since its last periodic report. The cost effectiveness concern reflected in the existing exemptions is accounted for in the proposal above by a waiver of this requirement where sells only a de minimis amount of equity—perhaps of few percent of its equity—in any given three month period. *See supra* Part II.A.

is *not* appropriate to do so in the case of the transactions contemplated by these other currently available exemptions. Again, our primary concerns are with the ability of the buyers to fully counteract the special incentive that the issuer has to make sales during the period between the issuer becoming aware of bad news and when it must disclose the news in a periodic filing and the special incentive that the issuer has not to comply with disclosure regulations in periodic filings made in anticipation of the offering. Unlike a transaction involving one or a few large institutional buyers, the buyers in these other transactions cannot be assumed to have the competence to negotiate and undertake a private due diligence process and contractual liability scheme that would satisfy these concerns. At least as important, collective action problems would rob them of the incentive to do so.

2. Avoiding Distortions Among Sources of Finance

Granting an exemption for private sales to institutional investors but not to the other sales that are currently exempt would also promote the goal of avoiding distortions in issuer choice among sources of finance. It avoids the no exemption approach's tilt toward internal funding that prevails when the public release of material information would be untimely, one of Professor Coffee's concerns. It also avoids any liability based distortion to an issuer's choice among sources of external finance because there is no longer any social interest in having the issuer choosing the alternative that would result in application of the public liability regime. Any gain to the issuer from choosing a private sale to institutional investors over a public one reflects an issuer calculation that the sum of the private approach's costs of issuer liability and the costs of the source of finance chosen (including the discount in sale price because of resale restrictions) are less than the sum of the costs of a public liability regime that serves the same social purposes and the costs of finance through a public offering.

C. Reflections on the Advisory Committee's Concerns

Viewed through the perspective of the approach developed here, many of the Advisory Committee concerns about allowing for a private placement exemption seem misplaced. Most of the complexities surrounding the current private placement regime can be eliminated. For example, there is no need to continue to worry about whether multiple private offerings occurring in some relatively short period should be "integrated" because, viewed together, they do not satisfy the traditional "too small" or "too few purchasers" cost effectiveness rationale for granting an exemption. In the scheme proposed here, because each individual transaction involving a sale to one or a few institutional purchasers will have terms that satisfy the concerns calling for imposing liability on the issuer in the case of a public sale, a

group of such offerings will also have terms that satisfy these concerns even if there are several transactions and they occur close in time to each other.

The same can be said of the current complex restrictions on resales by affiliates and statutory underwriters that were developed to prevent evasion of the registration rules by an initial private sale followed by the purchaser engaging in a public offering. There is no need for restrictions on sales by affiliates as long as their total sales in a given period satisfy the de minimis standard since adequate disclosure will be available on an ongoing basis. There is a need to continue the restriction for some given period of time on the resale of exempt securities purchased by institutional investors. The Advisory Committee's concern about the tendency of derivative securities to "merge" public and private markets for publicly traded securities in a way that eviscerates the resale restrictions seems overblown, however. A determination of whether the institutional purchaser should be regarded as having "sold" a restricted security by engaging in a derivatives transaction that effectively eliminates the risk of continuing to hold the security can be handled in the same way derivative transactions are handled under the 1934 Act § 16(b) rules permitting issuers to recover short swing profits from an insider purchase and sale of a security in less than six months.

It is true that having an exemption for sales to one or a few institutional purchasers would preserve the need for legal resources to advise as to, and police, the border between private and public transactions as well as rules concerning when resales are allowed. But in any legal regime, an attempt to tailor the regime to particular situations in ways that more precisely meet the regime's objectives is subject to this kind of objection. At least as far as the private costs are concerned, if the parties find them too burdensome, they need not avail themselves of the exemption. The exemption and the resale rules can be much more focused and simple than they are today since under company registration the reasons for treating issuers differently when they sell securities compared to when they do not are narrowed. Moreover, most of the resources that are today poured into maintaining the distinction between public and private transactions and allowable and not allowable resales either involve currently exempt transactions that my proposal would not exempt or deal with non-public or non-established issuers that will not be part of a company registration system in any event.

CONCLUSION

A company registration approach to securities disclosure regulation does not eliminate the need to decide whether there should be an exemption for private sales of securities from the liability provisions

imposed on the issuer in the case of public sales of securities. I recommend that there should be such an exemption when the sale is to one or a few institutional investors because such purchasers can negotiate private arrangements with the issuer that effectively meet the concerns that call for imposing liability on the issuer for public sales in the first place. The same cannot be said for the transactions covered by other exemptions available under the current transactionally based approach to securities regulation and so these exemptions should be eliminated.