ROBERT G. HUTCHINS - LEGAL BULLETINS

March 2011 - Hedge Funds Test the Ban on "General Solicitation" in Private Offerings

Overview

A senior lawyer at the SEC once observed, with irreverent but exquisite brevity, that the Securities Act of 1933 could be summarized thus: "Every offer and every sale of any security in the United States is either registered, exempt or illegal." Most issuers wish to avoid both registration and illegalities. They are therefore at pains to claim exemptions. The federal exemption most frequently invoked is provided by Section 4(2) of the Securities Act for "… (t)ransactions by an issuer not involving any public offering." The states have equivalent exemptions.

Section 4(2) permits issuers (but not reselling security holders) to offer and sell securities without registration by means of a "private offering" or "private placement." (Those terms, which technically distinguish the selling effort from the closing, are used interchangeably in general parlance.) In a bona fide private offering, the selling effort is confined to demonstrably "sophisticated" investors who can evaluate the merits and risks of purchasing the securities without the supervised disclosure registration would provide and who have an existing relationship with the issuer. It is generally agreed that mandatory registration of such offerings is not in the public interest. The high cost would impede capital formation for all but the largest issuers without increasing appreciably the protection of investors.[1]

There is no numerical benchmark for distinguishing private offerings from public ones. Under current law, however, an issuer relying on the Section 4(2) exemption must not seek investors by means of a "general solicitation," one calculated to reach the public at large. That prohibition is traceable to a 1935 SEC interpretive release and has become a cornerstone of private offering enforcement policy.[2]

Recently, that cornerstone came under attack on First Amendment grounds in a widely followed Massachusetts lawsuit. In *Bulldog Investors General Partnership, et al v. Secretary of the Commonwealth*, three hedge funds, their corporate manager, their investment adviser and its principals (collectively, "Bulldog") challenged a Cease and Desist Order of the Massachusetts' Securities Division that subjected Bulldog to an administrative fine and enjoined it from proceeding with an unregistered securities offering using certain internet communications.[3]

Bulldog had relied on the exemption from registration for "private offerings," but it also maintained an interactive website. Though there was no mention of specific securities, the website contained publicly accessible information about Bulldog's investment strategies and performance, including a statement that Bulldog delivered annual returns "significantly higher than …the S&P 500 Index." The website provided additional information to any visitor who clicked "I agree" in response to a disclaimer asserting that the information did "not constitute solicitation as to any investment...," was "not an invitation to subscribe for shares..." and "may not be used for …an offer or solicitation in any jurisdiction …or in any circumstances in which such offer or solicitation is unlawful…." Bulldog then replied to a general inquiry from a Massachusetts resident with an emailed invitation to discuss Bulldog's investments "in more detail." The Division claimed the website and email constituted an offering of securities by means of a "general solicitation" of the Massachusetts public in violation of that state's registration requirement.

Bulldog argued initially that its communications were non-commercial speech fully protected by the First Amendment. It noted the communications did not propose any commercial transaction and no one could have purchased a security by responding to them. The Division's Order was therefore an unconstitutional restraint on freedom of expression. The Division replied that the communications were not speech at all in a constitutional sense; merely conduct incidental to a "regulable transaction," the sale of securities.

The Massachusetts Court rejected both those positions. It ruled that while the communications did not convey offers to sell in the contract sense, neither were they limited to general information about Bulldog. Rather, they were a form of advertising the purpose of which was to condition the market for the sale of Bulldog's securities. As such, the communications were not immune from restraint. The legality of the Division's Order was to be determined by a four-prong test devised by the United States Supreme Court to mark the constitutional limits of restraints on commercial speech: First, does the speech provide truthful information about a lawful activity? Second, if so, is there nevertheless a substantial state interest that justifies regulation of the speech? Third, does the regulation directly advance the state's interest, as opposed to being ineffective or remote? Fourth, is the regulation reasonable in the sense of being "in proportion" to the state's interest, or could the interest be served as well by a less restrictive regulation?[4]

During an initial hearing, the Massachusetts trial judge characterized the Great Depression as a "catastrophic consequence" of the absence of securities regulation which resulted in the Securities Act of 1933 and its state counterparts. Mindful of that observation, the parties stipulated that while Bulldog's communications provided truthful information about lawful activities, Massachusetts had a substantial interest in preserving the integrity of its capital markets, and the health of its economy, by ensuring that investment decisions were made on a fully informed basis. That left as disputed matters only the third and fourth prongs of the Supreme Court's test: whether Massachusetts' interest was directly advanced by its solicitation ban and whether the ban restrained speech more than was necessary to secure the interest.

Based on the testimony of one Joseph Franco, an expert witness produced by the Securities Division, the Massachusetts Court ruled the ban did advance a substantial state interest directly, satisfying the third prong. Franco is "a law professor with specialized training and experience in economics and securities regulation." He opined that the ban was "critical" because it provides a "powerful incentive to register, despite the cost." Registration ensures full and accurate disclosure, which benefits not only specific purchasers, but also "the public as a whole, including regulatory officials, private analysts, large investors, and the news media," whose reporting is a "powerful check" on fraudulent practices. In addition, full disclosure "tends to result in market prices that accurately reflect value, for the benefit of all investors, both those purchasing the particular issue and those trading in other securities."

Bulldog responded that, even assuming Franco is correct, pushing issuers into registration by banning *any* general solicitation of investors is overreaching and violates the fourth prong. Bulldog proposed 11 alternative regulatory schemes each of which, it argued, was less restrictive, but as effective, as the Massachusetts scheme. None of the alternatives took effect until the time of sale and all permitted truthful pre-sale advertising and public solicitations of investment interest. They ranged from imposing investor eligibility or heightened seller disclosure standards (supported by some commentators) to flatly prohibiting the sale of unregistered securities in Massachusetts (proposed, one assumes, with tongue-in-cheek), or requiring that such securities be offered only to eligible investors licensed as such by the state (which, given the expectable level of compliance, would be of dubious utility). A final "alternative," emphasizing the enforcement of existing anti-fraud provisions, was simply a plea for the status quo.

As the Supreme Court put it, the precise issue addressed by the fourth prong was whether "the governmental interest could be served as well by a more limited restriction on commercial speech." The Massachusetts Court interpreted "as well" to mean "as effectively," at approximately the same cost in resources, both public (for administration and enforcement) and private (for compliance). In resolving that issue as it applied to Bulldog, the Court turned again to Professor Franco. He testified that none of the Bulldog alternatives could serve Massachusetts' interest "as effectively" as the current scheme. By permitting pre-sale solicitations, each alternative would encourage issuers to sell securities privately to avoid the cost of registration. That would increase "distortive" disclosures and sales to unqualified investors creating a "proliferation" of scams. Moreover, the alternatives would be enforced only after

sales were complete; when dissipation or concealment of the offering proceeds and the seller's other assets might impede recoveries by defrauded purchasers.

To counter this phase of Franco's testimony, Bulldog offered a 2006 Report to the SEC by its Advisory Committee on Smaller Public Companies and a supporting letter from the Committee on Securities Regulation of the New York City Bar Association. The Report recognized the importance of registration, but urged that the federal prohibition on general solicitation in private offerings be relaxed. The letter supported the Report and noted that the North American Securities Administrators Association endorsed both limited internet offering communications and a Model Accredited Investor Exemption promoted by general solicitation that at least 31 states had adopted. The Massachusetts court was not moved. It refused to draw any conclusions about the Division's Order based on the laws of other states.[5]

It is not clear to me how this issue ultimately will be resolved. The courts have been forced to grapple since 1933 with the truncated language of Section 4(2). The Section permits an issuer to decline to register any "transaction not involving a public offering." There is no explanation, no elaboration, no benchmark and no mention of advertising. Congress' rationale for enacting the Section may simply have been that non-public offerings, even if fraudulent, are apt to be local affairs not appropriate for federal intervention; a rationale that would have nothing to do with protecting investors. In any case, the connection between banning general solicitation and investor protection is murky at best. Proponents of the ban argue that advertised but unregistered securities tend to reach unsophisticated offerees unaccompanied by adequate disclosure. Opponents reply that focusing on offerees, rather than actual purchasers, is misplaced. Investors do not lose money on securities they never bought.

I do believe a regulation that permitted any advertising of unregistered securities so long as the content was "truthful" would be simplistic and easily abused. The disclosures necessary to describe investment risk are affirmative, comprehensive and nuanced. I doubt any court would deny to regulators the right to impose reasonable restrictions on solicitation patterned on existing regulations. For example, during a "quiet period" that begins 30 days before a registration statement is filed and ends 35 days after the statement is effective, issuers may not tout the securities covered by the statement publicly. However, after the statement is filed, even though it is not yet effective, the issuer's identity and contact information, brief factual information about its business and geographic markets, plus basic information about the offering (including the price or price range for the securities to be sold) may be published.[6]

Small offerings by qualified private issuers can be promoted using pre-sale advertising and are exempt from federal registration if made in compliance with Rule 504 of SEC Regulation D. Such offerings cannot seek more than $1 million in any 12 consecutive-month period and must be registered in at least one state. The related state laws require that pre-sale advertisements be approved in advance by the state's securities administrator. The content is limited to a brief announcement that identifies the issuer, the offering and the securities and is accompanied by a statement that no money will be accepted, and no purchase commitment will be binding, until the purchaser has received a full disclosure memorandum.[7]

Meanwhile, the Bulldog opinion states the law in Massachusetts as follows: The Massachusetts Uniform Securities Act protects that state's substantial interest in preserving the integrity of its capital markets and the health of its economy. The Act does this, in part, by prohibiting issuers from promoting their securities using any form of general solicitation unless they have first submitted their offering documents to regulatory scrutiny through the registration process. That prohibition encourages registration and thus effectively and directly advances the state's interest. The prohibition is "proportionate" because it requires merely that offerings be registered before public solicitation begins and thus falls well short of an outright prohibition of commercial speech. While the cost of registration may impede capital formation to some extent, the greater economic good is served by ensuring that investors who provide capital are fully informed. It remains to be seen whether other courts will agree.

Endnotes

[1] For a comprehensive discussion of the legal issues presented by private placements, see www.hutchins-law.com/publications/corporate/finance *"Private Placements" Parts I - IV*.

[2] See, Release 33-285 (available January 24, 1935) stating that factors for determining whether an offering is "public" include (a) the number of offerees (no benchmark is mentioned) and their relationship to each other and to the issuer (preliminary communications to identify investors, if directed to a "substantial" number of persons, would "involve a public offering," while communications to persons with special knowledge of the issuer are less likely to be "public"); (b) the number of units offered (small denominations suggest a public offering); (c) the size of the offering (large offerings or offerings of securities already traded on an exchange, are more likely to be "public"); and (d) the manner of offering (direct negotiations by the issuer are "much more likely" to be non-public).

[3] See, 457 Mass. 210 (2010). One of the Bulldog principals is Philip Goldstein, whose earlier challenge to an Investment Advisers Act Rule was famously successful. Goldstein's firm wanted to rely on the "private adviser" exemption from registration then available to advisers with fewer than 15 clients. It challenged a new Rule that required hedge fund advisers to count as "clients" all fund investors; even if the advice was provided only to the fund as a separate legal entity. Goldstein persuaded the Court of Appeals for the DC Circuit that the fund itself was the relevant client. Unless his firm was advising them personally, the fund investors were not its clients and the SEC had no authority to make them such. The SEC did not appeal the decision. See, *Goldstein v. SEC*, 451 F.3d 873, (D.C. Cir. 2006). As of July 21, 2011, however, the Dodd Frank Act does away with the "private adviser exemption." Advisers to private funds will, depending on the dollar amount of assets under management and other factors, be required either to file certain reports and maintain various records or to submit to full federal registration. The SEC has proposed new Rules to implement Dodd Frank. See, e.g., Proposing Releases IA 3111, *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management and Foreign Private Advisers*, available November 19, 2010; IA 3145 *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators on Form PF*, available January 26, 2011; and IA 3098, *Family Offices,* available October 12, 2010.

[4] See, *Central Hudson Gas and Electric v. Public Service Commission*, 425 U.S. 748, 762 (1980).

[5] See, *Final Report: Advisory Committee on Smaller Public Companies*, www.sec.gov/info/smallbus/acspc/acspc-finalreport. Washington prohibits any general solicitation in private offerings, but will take no action with respect to (a) internet offerings that are registered or made pursuant to a perfected exemption or (b) internet communications that indicate the securities are not being offered in Washington, provided the offer is not otherwise directed to a Washington resident. See, www.dfi.wa.gov/sd/securitiespolicy.htm *Securities Act Policy Statement - 16.*

[6] See, SEC Rules 134 and 135.

[7] Rule 506 of Regulation D, which covers most private offerings by issuers, imposes purchaser eligibility and issuer disclosure requirements at the time of sale, but it also retains intact the full ban on general solicitation. See, www.hutchins-law.com/publications/corporate/finance *"Private Placements Part III - Organization and Structure."* The Washington counterpart to the federal Rule 504 exemption is the so-called "Small Corporate Offering Exemption" in which an offering of up to $1 million may be registered in a simplified format on a question and answer "SCOR" form, certain restrictions respecting promoter's shares, insider loans and securities with junior voting rights are relaxed and public solicitation is permitted. See, www.dfi.wa.gov.sd/scor.htm.

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