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PRIVATE PLACEMENTS: WILL FINRA SINK IN THE SEA CHANGE?

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I. INTRODUCTION

Private placements take place when a company sells securities outside of the normal public securities markets. Today, private offerings outpace their public counterparts both in terms of numbers and dollar volume. While sales to institutional investors represent the largest volume of these sales, nonpublic securities are also sold to retail purchasers.[1] In today's low interest rate climate, alternative investment opportunities promising a fairly high rate of return are attractive to investors who were previously content with safer alternatives such as corporate or treasury bonds.[2] Nevertheless, most retail investors do not independently seek to purchase securities in nonpublic offerings. Instead, they enter these investments upon the recommendation of intermediaries, including stockbrokers and investment advisors.[3] Stockbrokers are regulated by the self-regulatory organization known as the Financial Industry Regulatory Authority (FINRA), while investment advisors are regulated either by the Securities and Exchange Commission (SEC) or state securities authorities. As events have unfolded, the regulations and enforcement procedures applicable to the intermediaries provide the only real protection to investors who purchase private placements.

This Article examines the burgeoning growth of private placement

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1. The term "retail investor" as used in this paper means individual or household investors as opposed to institutions such as banks, pension funds, and insurance companies. Retail investors may or may not qualify as accredited investors under SEC rules. *See infra* note 26.

2. For example, Massachusetts Secretary of State William Galvin recently subpoenaed bank records to investigate sales of risky high yield alternative products to senior citizens. Deirdre Fernandes, *Galvin Subpoenas Banks for Details*, BOSTON GLOBE, July 11, 2013, *available at* http://www.bostonglobe.com/business/2013/07/10/secretary-state-william-galvin-subpoenas-big-banks-and-investment-firms-probing-sales-alternative-assets-seniors/CKYc5JRyVgTsA21cUSYdLM/story.html; *see also* Nathaniel Popper, *Speculative Bets Prove Risky as Savers Chase Payoff*, N.Y. TIMES, Feb. 10, 2013, *available at* http://www.nytimes.com/2013/02/11/business/wave-of-investor-fraud-extends-to-ordinary-retirement-savers.html?pagewanted=all&_r=0.

3. A recent SEC study demonstrates that retail investors often lack financial literacy and depend upon broker/dealers and other financial advisors for investment advice. SEC, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS, vii–viii, (Aug. 2012), *available at* http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

activity in the United States securities markets and FINRA's role in policing the private placement activity of its registered broker/dealer firms and associated sales representatives. In Part II, the Article presents a brief overview of FINRA and its status as a Self-Regulatory Organization (SRO). In Part III, the Article chronicles the federal regulatory scheme that allows private placements to escape virtually all governmental scrutiny. Part III also explains the regulatory and judicial developments that have simultaneously eased the regulation of private placements while making it more difficult for injured investors to recover their losses. In Part IV, the Article presents empirical data on the size and scope of the private placement market, particularly as it impacts retail investors. This data clearly demonstrates that private offerings are the predominant method of capital formation, both in terms of the raw numbers of offerings and total dollar volume. Part V details two new FINRA rules designed to protect investors who purchase private offerings from their brokers. Part VI presents empirical data on FINRA enforcement activity in the private placement arena in the past decade. The data shows that until very recently, FINRA's enforcement efforts have been quite poor. Part VII concludes with the observation that, as the only private placement cop on the beat, FINRA must take its regulatory responsibilities most seriously. With new initiatives such as CrowdFunding and advertised private offerings, Congress is imposing ever-increasing enforcement responsibility upon the SRO. FINRA must resist the inevitable industry pressure and enact and enforce sensible rules to protect investors.

II. THE ROLE OF FINRA

Many retail investors who directly enter the securities markets utilize the services of an intermediary—either a broker/dealer or a Registered Investment Advisor (RIA).[4] RIAs are governed by the 1940 Investment Advisers Act[5] and regulated by the SEC or state securities regulators, depending upon the size of assets under management.[6] Broker/dealers

4. Far more retail investors invest indirectly through intermediary investment vehicles such as mutual funds or pension plans. *See, e.g.*, Brian Cartwright, SEC Gen. Counsel, Address Before the University of Pennsylvania Law School Institute for Law & Economics: THE FUTURE OF SECURITIES REGULATION (Oct. 24, 2007), *available at* http://secsearch.sec.gov/search?utf8=%E2%9C%93&sc=0&query=brian+cartwright+future+of+securities&m=&affiliate=secsearch&commit=Search (explaining that retail stock "ownership now is increasingly intermediated by mutual funds and other collective vehicles"); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 PA. LAW REV. 1961 (2010) (suggesting reforms to the regulation of collective pool intermediaries).

5. Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1–21 (2006)).

6. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 410,

are governed by the provisions of the 1934 Securities Exchange Act[7] and regulated by both the SEC and FINRA. FINRA is an SRO established in 2007 through the consolidation of the regulatory functions of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE).[8] Among its regulatory undertakings, FINRA promulgates and enforces rules; enforces federal securities laws and regulations; and operates a mandatory arbitration system for disputes between broker/dealers and their customers, as well as disputes among FINRA members.[9] Soon FINRA will take on additional responsibility as the regulator of CrowdFunding intermediaries, including broker/dealers and the newly established Funding Portals.[10] In addition, FINRA makes no secret of the fact that it would like to replace the SEC as the regulator of RIAs, and the SRO has engaged in an intense Congressional lobbying effort to attain this status.[11]

FINRA is a very large and quite powerful SRO, despite some evidence that in terms of raw numbers, the broker/dealer community is shrinking.[12] Today FINRA regulates the activities of 4,300 brokerage firms, over 161,000 branch offices, and approximately 630,000 registered securities representatives.[13] This Article focuses on FINRA's regulation of one segment of broker/dealer activity: broker/dealers who participate in the sale of nonpublic offerings, particularly those conducted under the Rule 506 private placement safe harbor from the 1933 Securities Act.[14] While FINRA has attracted many critics,[15] the

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124 Stat. 1376, 1576–77 (2010) (codified at 15 U.S.C.A. § 80b-3a (West 2013)).

7. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–pp (2006)).

8. Maloney Act, ch. 677, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C.A. § 78o-3 (West 2013)); (creating Self-Regulatory Organizations); Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Release No. 34-56145, File No. SR-NASD-2007-023 (July 26, 2007), *available at* http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

9. 15 U.S.C.A. § 78o-3(a), (b).

10. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 301–05, 126 Stat 306, 315–23 (2012).

11. Melanie Waddell, *Ketchum's Big SRO Omission*, INVESTMENT ADVISOR (Feb. 25, 2013), *available at* www.advisorone.com/2013/02/25/ketchums-big-sro-omission (explaining that FINRA is shifting its SRO lobbying effort to the Senate); Bruce Kelly, *FINRA Outlines Expansion*, INVESTMENT NEWS, May 28, 2012, at 1. Recently FINRA made its arbitration forum available on a voluntary basis to RIA disputes. *See* FINRA, GUIDANCE ON DISPUTES BETWEEN INVESTORS AND INVESTMENT ADVISERS WHO ARE NOT FINRA-REGULATED FIRMS, *available at* http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/p196162.

12. Bruce Kelly, *Choppy Waters Persist*, INVESTMENT NEWS, Jan. 21, 2013, at 10.

13. FINRA, 2012 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 8, *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p291721.pdf.

14. 17 C.F.R. § 230.506 (2011).

15. *See, e.g.*, Ben Protess, *Finra Executives Get Big Payday*, N.Y. TIMES DEALBOOK (July 1,

SRO is, for better or worse, the only national cop on the beat to police private placements.[16]

III. REGULATION OF PRIVATE PLACEMENTS

In a private placement, an issuer sells securities outside of the public securities markets pursuant to an exemption from Section 5 of the 1933 Securities Act.[17] Section 5 of the 1933 Act provides that issuers must register all offers and sales of securities in interstate commerce with the SEC or find an exemption from registration.[18] The private placement exemption is contained in section 4(a)(2) of the 1933 Act, which exempts nonpublic offerings.[19] As interpreted by the U.S. Supreme Court, however, the section 4(a)(2) exemption is only available for offers and sales to sophisticated investors who can "fend for themselves."[20] According to the Court, private placement investors must have access to "the kind of information which registration would disclose" and the business sophistication to understand it.[21] Dissatisfied with the uncertain, subjective nature of *Ralston Purina*'s test of investor

2011, 10:54 AM), *available at* http://dealbook.nytimes.com/2011/07/01/finra-executives-get-big-payday/; Steven M. Davidoff, *The Government's Elite and Regulatory Capture*, N.Y. TIMES DEALBOOK (June 11, 2010, 2:00 PM), *available at* http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture/; Letter from Angela Canterbury & Michael Smallberg to Chairman and Ranking Member, House and Senate Comms. (May 29, 2012), *available at* http://www.pogo.org/our-work/letters/2012/fo-fra-20120529-finra-investment-advisers.html (opposing self-regulation of investment advisers).

16. The SEC also polices broker/dealer activity but focuses its limited resources on the 20 largest broker/dealers, major fraudulent activity, and broker/dealers with dual registration as investment advisors under the agency's direct supervision. *See generally* Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679 (2012) (presenting results of a study of SEC enforcement activities against broker/dealer activities in 1998 and from 2007 to 2008). For an example of SEC enforcement activities, see John Thomas Capital Mgmt. Grp., LLC, File No. 3-15255, 2013 SEC LEXIS 922 (Mar. 22, 2013) (SEC charges brokerage firm founder and fund manager with fraud); Mark Schoeff, Jr., *Dually Registered Advisers in SEC Sights*, INVESTMENT NEWS, (Mar. 3, 2013), *available at* http://www.investmentnews.com/article/20130303/REG/303039963#.

17. Securities Act of 1933, ch. 38, § 4(2), 48 Stat. 74, 77 (codified as amended at 15 U.S.C.A. § 77d(a)(2) (West 2013)); 17 C.F.R. § 230.506 (2011).

18. 15 U.S.C. § 77e (2006).

19. Section 4(a)(2) of the 1933 Act exempts "transactions by an issuer not involving a public offering." 15 U.S.C.A. §77d(a)(2) (West 2013). Until the 2012 JOBS Act Amendments, section 4(a)(2) was known as section 4(2). *See* Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 201(b), 126 Stat 306, 314 (2012).

20. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

21. *Id.* at 126–27. Cases subsequent to *Ralston Purina* have clarified that the disclosure test is disjunctive and that issuers could meet the section 4(a)(2) exemption of the 1933 Act either by disclosing information to sophisticated investors or providing effective access to the relevant information. Doran v. Petroleum Mgmt., 545 F.2d 893, 904–06 (5th Cir. 1977).

sophistication[22] small business issuers, their attorneys, and their lobbyists convinced Congress,[23] and then the SEC, to adopt an objective, more predictable test for the private placement exemption. In 1982, after a few false starts,[24] the SEC adopted Rule 506 of Regulation D to provide a safe harbor for private offerings under section 4(a)(2) of the 1933 Act.[25] Rule 506 exempts sales to defined "accredited investors" from 1933 Act registration. In general terms, Rule 506 defines accredited investors as institutional investors of a certain size and individuals deemed to be wealthy, at least by 1982 standards.[26] The theory, perhaps belied by recent events,[27] is that accredited investors do not need the full protection of the federal securities laws because they have either the sophistication or the resources to both obtain disclosure and evaluate the merits of private securities offerings.[28] In fact, in keeping with this self-help rationale, the SEC does not review private

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22. *Ralston Purina* followed an earlier SEC interpretation of then section 4(2) by the SEC's General Counsel stating that "the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment." Letter of General Counsel Discussing the Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, Fed. Sec. L. Rep. (CCH) ¶¶ 2,740 at 2,744 (Jan. 24, 1935). After *Ralston Purina*, the SEC further contributed to the uncertainty of the *Ralston Purina* test by enumerating a number of factors that should be taken into account in assessing the availability of the section 4(2) exemption. *See* Non-Public Offering Exemption, Release No. 33-4552, 27 Fed. Reg. 11316 (Nov. 6, 1962).

23. Congress responded with a statutory exemption for annual sales of no more than $5 million to "accredited investors." Small Business Issuer's Simplification Act of 1980, Pub. L. No. 96-477, 94 Stat. 2294 (codified at 15 U.S.C. § 77d(6) (2006)). The amendments defined "accredited investor" to include specific institutional investors and individuals of a certain wealth or sophistication as permitted by SEC rule. 15 U.S.C. § 77b(a)(15) (2012).

24. *See* Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L. Q. 225, 236–42 (1990) (summarizing the SEC's prior attempts to promulgate an acceptable private placement safe-harbor rule).

25. 17 C.F.R. § 230.506 (2011).

26. 17 C.F.R. § 230.501(a) (2011). Under Rule 501(a) the term "accredited investor" includes insiders, large institutional investors, and natural persons who have an annual income in excess of $200,000 ($300,000 with their spouse) or at least $1 million dollars in net assets excluding the value of their primary residence. *Id.*

27. For example, Bernie Madoff's investors consisted of wealthy individuals, hedge funds, and institutional investors including charities, all defined as "accredited" under Rule 501(a). *See* Felicia Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor"*, 40 U. BALT. L. REV. 215, 233–34 (2010). Investor losses as a result of the Madoff fraud, however, were legendary. For one account of the victims and their losses, see Annelena Lobb, *For Victims, Downsized Lives and Many Shattered Dreams*, WSJ.COM (June 29, 2009, 11:59 PM), *available at* http://online.wsj.com/article/SB124623313963566369.html.

28. The premise that wealth is an appropriate surrogate for sophistication is controversial. *See generally* Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299–301 (1994) (criticizing rules that equate wealth with sophistication); 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, 382 (1984) (arguing that wealthy investors may not have the sophistication to evaluate the merits and risks of private placement investments).

placement offerings even for minimal compliance with its rules.[29]

Under Rule 506, there is no mandated disclosure if sales are made only to accredited investors.[30] Rule 506 does contain resale restrictions,[31] and as originally promulgated, it prohibited the general solicitation of investors.[32] Title II of the 2012 Jumpstart Our Business Startups Act (the JOBS Act) required the SEC to amend Rule 506 to permit advertising and general solicitation.[33] Consistent with this mandate, the Commission recently adopted new Rule 506(c), which allows issuers to advertise private placements if they take reasonable steps to verify that all purchasers of the securities are in fact accredited.[34]

While Rule 503 requires issuers to file a Form D with the Commission to access the Rule 506 exemption,[35] failure to file is deemed an "insignificant deviation" that does not destroy the exemption.[36] Form Ds are considered notice filings and historically, the

29. Office of Inspector General, Regulation D Exemption Process Report No. 459, 8 (Mar. 31, 2009) [hereinafter OIG 2009 Report]. The OIG 2009 Report noted that the SEC depends upon the "honor system" for filers to fill out Form D. *Id.* at 8–10.

30. *See* 17 C.F.R. § 230.502(b)(1) (2011). Private placement issuers, however, generally provide disclosures for antifraud purposes, although the quality of the disclosures varies widely.

31. 17 C.F.R. § 230.502(d) (2011). Privately placed securities are "restricted" in the sense that they may not be resold without an exemption. *Id.* The most common exemptions are section 4(a)(1) of the 1933 Act, 15 U.S.C.A. § 77d(a)(1) (West 2013); 17 C.F.R. § 230.144 (2011); and SEC Rule 144, 17 C.F.R. § 230.144A (2011).

32. Originally, Rule 502(c) prohibited general solicitation or advertising, effectively restricting Rule 506 offerings to those investors with whom the issuer or its selling agent has a pre-existing relationship. 17 C.F.R. § 230.502(c) (2008).

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

34. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415 (July 10, 2013). Section 926 of the 2010 Dodd–Frank Act required the SEC to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on Rule 506. In response, the SEC adopted Rule 506(d), Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414 (July 10, 2013).

35. 17 C.F.R. § 230.503(a)(1) (2008).

36. Rule 508 provides that the exemption will not be lost for an "insignificant" deviation from the rule including failing to file the Form D. 17 C.F.R. § 230.508(a) (2008); SECURITIES ACT RULES, QUESTIONS AND ANSWERS OF GENERAL APPLICABILITY, *available at* http://sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (Answer to Question 257.07). Rule 507, however, adopted in 1989, provides that an adjudicated failure to file a Form D will disqualify the issuer from future use of Regulation D. 17 C.F.R. § 230.508(a) (2011); Accredited Investor and Filing Requirements, Release No. 33-6825, 54 Fed. Reg. 11369 (Mar. 20, 1989). I have found only one example of an SEC action against an issuer for failing to file Form D. *See* SEC v. Ludlum, No. 10-7379 (E.D. Pa. Mar. 15, 2011) (order enjoining defendants for, among other things, failing to file a Form D for a Regulation D offering). On July 10, 2013 the SEC proposed a new rule to establish sanctions for failure to file a Form D. *See* Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13 (July 10, 2013) [hereinafter Amendments to Regulation D, Form D and Rule 156 under the Securities Act].

SEC staff has not reviewed them for regulatory compliance or to address antifraud concerns.[37] In any event, the required form does not give the Commission the information it would need for a substantive review.[38]

At one time, state securities officials provided the regulatory backup for reviewing these private offerings that are virtually ignored by federal officials. In 1996, however, Congress preempted state presale authority over Rule 506 private placements,[39] thus creating a vacuum in which even suspicious investment schemes can proliferate below any governmental radar screen. In an earlier paper, I referred to Rule 506 private placements as a "Regulatory Black Hole."[40] Unfortunately, the North American Securities Administrators Association (NASAA) reports that Rule 506 offerings "continue to rank as the most common product or scheme leading to investigations and enforcement actions by state securities regulators."[41]

In addition to state preemption and the new SEC advertising rule mandated by the JOBS Act, there have been a number of additional regulatory and judicial developments that have simultaneously eased the regulation of private placements and made it more difficult for injured investors to recover their losses.[42]

For example, the wealth standard that defines "accredited investors" for natural persons has not changed since 1982, with the exception of the 2010 Dodd–Frank "do not count the house" amendment.[43] Under current definitions, investors are accredited if they have a net worth in excess of $1 million (not including the investor's primary residence) or an annual income in excess of $200,000.[44] In today's dollars, these

37. OIG 2009 Report, *supra* note 29, at 8.

38. *Id.* at 50 (comments from SEC Division of Corporate Finance). As amended in 2009, Form D only requires information concerning the date of first sale, limited information about the issuer, and recipients of sales commissions. *Id.* at 6. It is not necessary to file a copy of disclosure statements. *See id.* at 20–22 (recommending improvements to Form D). On July 10, 2013, the SEC proposed a number of new rules, which, among other purposes, are intended to enable the Commission to obtain more information on Rule 506 offerings. *See* Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *supra* note 36.

39. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102(a), 110 Stat. 3416, 3417–18 (codified as amended at 15 U.S.C.A. § 77r(a), (b)(4) (West 2013)).

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

41. NASAA, *Top Investor Threats, available at* http://www.nasaa.org/3752/top-investor-threats/.

42. *See generally* William K., Sjostrom, Jr., *Berle IV: The Future of Financial and Securities Markets the Fourth Annual Symposium of the Adolf A. Berle, Jr. Center on Corporations, Law, and Society: Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143 (2013); Donald C. Langevoort & Robert. B. Thompson, *"Publicness" in Contemporary Securities Regulation after the JOBS Act*, 101 GEO. L. J. 337, 349–51 (2013).

43. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010) (codified as a note to 15 U.S.C.A. § 77b (West 2013)).

44. 17 C.F.R. § 230.501(a)(5) (2011).

standards equate to a net worth of approximately $2.4 million or an annual income of approximately $470,000. Pursuant to Dodd–Frank,[45] the SEC is studying the continued wisdom of the 1982 wealth metrics,[46] but previous Commission attempts to increase the wealth threshold have met stiff resistance from the business community.[47]

Unlike registered securities, private placement securities such as those issued pursuant to Rule 506 are not freely tradable in the public markets. Instead, Rule 506 securities are "restricted" and investor resales must comply with a 1933 Act exemption.[48] Over time, however, private securities have become increasingly liquid. For example, Rule 144 removes the resale restrictions for nonaffiliated purchasers of restricted securities who hold the securities for a certain period of time.[49] Over the years, the SEC has significantly shortened the Rule 144 holding period. While at one time a nonaffiliate could not freely trade restricted stock for three years,[50] today the holding period is six months for public company stock and one year for securities of private entities.[51] Also, trading platforms have emerged to provide a secondary market for trading restricted securities.[52] While not entirely free of SEC and FINRA oversight, these platforms have not yet been subject to the extensive regulations that govern exchanges trading the securities of public issuers.[53] Also, the JOBS Act increased the number of shareholders who can own stock in a private entity before triggering 1934 Act disclosure and other obligations that apply to public

45. Dodd–Frank Wall Street Reform and Consumer Protection Act § 413(b).

46. On July 10, 2013, the SEC announced that its staff was beginning a review of the appropriate definition of "accredited investor" and requested comments. *See* Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *supra* note 36.

47. *See, e.g.*, Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8825, 72 Fed. Reg. 45116, 45126 (proposed Aug. 10, 2007).

48. 17 C.F.R. § 230.502(d) (2011).

49. 17 C.F.R. § 230.144 (2011).

50. *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 33-6806, 42 SEC Docket 76 (Oct. 25, 1988) (establishing 3 year rule for nonaffiliates).

51. 17 C.F.R. § 230.144(d)(1) (2011). For a detailed explanation of the changes to Rule 144 over the years, see Sjostrom, *supra* note 42, at 1149–51.

52. *See* Langevoort & Thompson, *supra* note 42 (discussing the emergence of trading platforms to trade private company shares).

53. *But see Sharespost, Inc. & Greg B. Brogger*, Release No. 66594, 2012 SEC LEXIS 821 (Mar. 14, 2012) (consent decree requiring that SharesPost maintains a trading platform for nonpublic securities to register as a broker/dealer and pay $100,000 fine). On March 6, 2013, NASDAQ announced that it will enter into a joint venture with Sharespost's private company market place exchange and rebrand it the NASDAQ Private Exchange. *NASDAQ OMX and SharesPost to Form Private Market*, NASDAQ OMX (Mar. 6, 2013), *available at* http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=745594. The NASDAQ Private Market launched March 5, 2014.

companies from 500 to 2,000.[54] These increased resale options have lowered the traditional illiquidity discount in pricing the sale of restricted securities, thus increasing the popularity of private offerings.[55]

While regulatory changes have lightened the requirements for issuers to sell securities privately, developments in the liability sphere have made it more difficult for defrauded investors to recover their losses. Under federal law, Rule 506 investors' only recognized cause of action is pursuant to an implied cause of action under section 10(b)[56] and Rule 10b-5[57] of the 1934 Securities and Exchange Act, which prohibit fraud in connection with the purchase or sale of any security.[58] Over several decades and with occasional congressional adjustments, courts have concluded that to establish a prima facie case under Rule 10b-5, a private plaintiff must generally plead and prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the material misstatement of fact or omission and the purchase or sale of securities; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[59] In the Private Securities Litigation Reform Act of 1995,[60] Congress tightened the pleading requirements for Rule 10b-5 plaintiffs, dictating that in order to defeat a motion to dismiss, plaintiffs must, before discovery, state with particularity facts detailing the fraud[61] and "giving rise to a strong inference that the defendant acted with the

54. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 501, 126 Stat 306, 325 (2012) (codified as amended at 15 U.S.C.A. § 78l(g)(1)(A)(i) (West 2013)). For an extensive discussion of the gateways that lead to public company status under the 1934 Act, see Langevoort & Thompson, *supra* note 42, at 351–55.

55. *See* Revision of Holding Period Requirements in Rule 144 and 145, Securities Act Release No. 7390, 63 SEC Docket 2077 (Feb. 20, 1997) (stating that shorter holding periods should lower the illiquidity discount inherent in private offerings and reduce the cost of capital).

56. Securities Exchange Act of 1934, ch. 404, § 10, 48 Stat. 891 (codified as amended at 15 U.S.C.A. § 78j (West 2010)).

57. 17 C.F.R. § 240.10b-5 (2010).

58. Before 1995, it was commonly understood that private placement investors could recover under section 12(a)(2) of the 1933 Act, which provides a negligence-based recovery for purchasers who are in privity with their sellers. In 1995, however, the Supreme Court, in *Gustafson v. Alloyd Co., Inc.*, held that section 12(a)(2) only applied to disclosures utilized in a public offering. 513 U.S. 561, 569–70 (1995). While widely criticized, the *Gustafson* decision has not been overturned either by the Court or Congress with respect to private offerings. In an interesting move, however, Congress did mandate that section 12(a)(2) applies to CrowdFunding cases. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 302(b), 401(a), 126 Stat 306, 319, 323 (2012) (codified as amended at 15 U.S.C.A. §§ 77c(b)(2)(D), 77d-1(c)(1)(B) (West 2013)).

59. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (internal citations omitted); *see* Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463, 467–71 (2011) (detailing the Rule 10b-5 cause of action).

60. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

61. 15 U.S.C.A. § 78u-4(b)(1), (b)(3)(A)–(B) (West 2010).

required state of mind" (scienter).[62] While motivated by a desire to thwart abusive class action litigation,[63] by its terms, the PSLRA also applies to individual suits by plaintiffs alleging Rule 10b-5 securities fraud. While some investors may challenge public company private placements, most allege fraud in connection with sales by private issuers.[64] The PSLRA thus imposes a heavy burden for these investors to establish fraud and scienter without discovery.[65] Moreover, under controlling Supreme Court precedent, private placement investors do not have a Rule 10b-5 cause of action for participant or aiding and abetting liability.[66]

Investors challenging fraud in connection with Rule 506 sales fare somewhat better in state court. Most state blue-sky laws contain negligence based liability provisions, and under state law there is a robust aiding and abetting cause of action.[67] To be sure, there can still be jurisdictional[68] and even constitutional challenges under state statutes,[69] and provisions of the 1998 Securities Litigation Uniform

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62. *Id.* § 78u-4(b)(2)(A). In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Supreme Court clarified that to successfully plead scienter, "the inference of scienter must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations." *Id.* at 324.

63. *See* H.R. Conf. Rep. No. 104-369, at 31 (1995) (discussing "the routine filing of lawsuits . . . with only a faint hope that the discovery process might lead eventually to some plausible cause of action").

64. From 2008 to 2012, approximately 13% of nonfund private placement offerings were by SEC reporting public companies accounting on average for 2% of the total amount sold. *See* Vladimir Ivanov and Scott Bauguess, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012* (July 2013), at 14, 19–20 [hereinafter 2013 SEC Staff Study], *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

65. Plaintiff-friendly theories such as the "fraud on the market theory" presuming materiality in an efficient market do not apply to the vast majority of private offerings. Basic Inc. v. Levinson, 485 U.S. 224, 242–43 (1988).

66. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 170–78 (1994); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 157–58 (2008). In *Janus Capital Group., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), the court held that under Rule 10b-5, "the maker of a statement" for purposes of Rule 10b-5 primary liability is only "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* at 2302. It is possible that Dodd–Frank amendments to section 9 of the 1934 Act may have inadvertently provided an additional cause of action against broker/dealers. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 762(d)(2)(a), 124 Stat. 1376, 1760 (2010).

67. In an earlier paper I presented an extensive analysis of blue-sky liability for primary and secondary participants in securities fraud. *See* Johnson, *supra* note 59, at 475–85.

68. *In re* Nat'l Century Fin. Enters., Inc., Inv. Litig., 755 F. Supp. 2d 857, 888 (S.D. Ohio 2010) (out of state investors could sue under Ohio blue-sky liability provisions). *See* Robert N. Rapp, *Misapplication of the Federal Extraterritoriality Principle in Limiting the Scope of Civil Remedies for Fraud Under State Blue Sky Laws*, 39 SEC. REG. L. J. 279 (2011).

69. *See, e.g.*, Houston v. Seward & Kissel, LLP, No. 07-cv-6305(HB), 2008 WL 818745, at *5–6 (S.D.N.Y. Mar. 27, 2008) (rejecting commerce clause challenge to application of Oregon securities statute to out of state defendant).

Securities Act can dampen the enthusiasm for plaintiffs to bring state court class actions.[70]

Historically, when the dispute over a private placement involved a registered broker/dealer, the investor's only dispute resolution alternatives were FINRA arbitration or participation in a class action.[71] Virtually every investor signs an account form with her broker/dealer that contains a mandatory arbitration clause.[72] The U.S. Supreme Court has upheld such mandatory clauses against challenges that they were impermissible waivers of investors' rights under the federal securities laws.[73] Under FINRA Rule 12204, investor claims will not be arbitrated if the investor participates in a judicial class action.[74] FINRA rules also prohibit registered firms from including judicial class action waivers in their account contracts.[75]

IV. THE DATA: AN EXPANDING PRIVATE PLACEMENT MARKET

In light of these developments, the Rule 506 private placement market has grown exponentially.[76] While precise numbers are not available, by any measure the market is very large, reaching into the hundreds of

70. Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.). SLUSA precludes most class actions based upon state blue-sky laws. *Id.* § 101(a). SLUSA does not apply to state securities fraud class actions resulting from privately placed securities by nonpublic companies or privately placed debt securities. 15 U.S.C. § 78bb(f)(5)(E) (2006); 15 U.S.C. § 77p(f)(3) (2006). Plaintiffs' attorneys nonetheless shy away from state class actions due to the expense of litigating the automatic removal and resulting remand motions. Moreover, class actions involving over a hundred claimants and $5 million dollars can usually be removed to federal court under provisions of the 2005 Class Action Fairness Act (CAFA), Pub. L. No. 109-2, 119 Stat. 4 (codified in scattered sections of 28 U.S.C.). For an in-depth analysis of the impact of SLUSA and CAFA on state securities litigation, see Johnson, *supra* note 59, at 487–92.

71. *See* Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 124 (2005) (explaining and critiquing mandatory FINRA arbitration).

72. *Id.* at 131–32.

73. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 226–27, 238 (1987).

74. FINRA Rule 12204(b). This rule also provides that FINRA will not conduct class action arbitrations. FINRA Rule 12204(a), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4110.

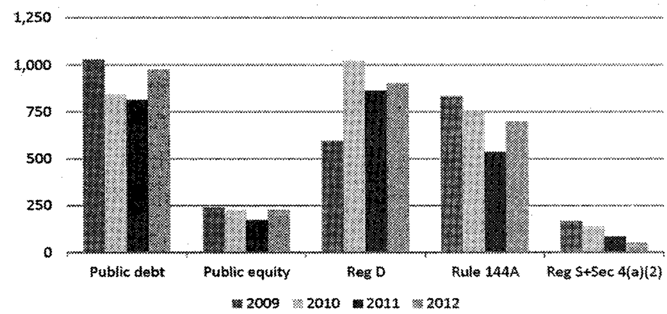
75. *Id.* FINRA Rule 2268(f) requires broker/dealers to include language in their account agreements acknowledging that they may not force customers to arbitrate if they are a member of an ongoing class action, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13595&element_id=9955&highlight=2268#r13595. The validity of FINRA's class action rule was in question—given a successful challenge by Charles Schwab before a FINRA hearings panel. The FINRA panel found the rule invalid under current U.S. Supreme Court arbitration jurisprudence. Subsequently, FINRA's Board reversed the hearings panel and Schwab settled agreeing to a $500,000 fine.

76. Only recently with the advent of mandatory electronic Form D filing requirements have meaningful statistics become available to calculate the number and volume of Rule 506 private placements. 17 CFR § 230.503(a)–(b).

billions of dollars each year.[77]

A 2013 study by SEC staff for the Commission's Division of Economic and Risk Analysis[78] demonstrates that as of 2010, in terms of aggregate dollar volume, Regulation D offerings had become the dominant offering method for raising capital in the U.S.[79] Table One shows that from 2010 to 2012, the total dollar volume for all Regulation D offerings exceeded the volume of any other method of equity capital formation.[80]

Table 1: Aggregate Capital Raised in 2009–2012 by Offering Method ($ billions)



77. To access the Rule 506 exemption, SEC Rule 503 requires issuers to file a Form D with the Commission within 15 days after first sale. 17 C.F.R. § 230.503(a)(1). Form D solicits information on the "total offering amount" and the "total amount sold" at the time of filing. SEC Form D, 3, *available at* http://www.sec.gov/about/forms/formd.pdf. The "total offering amount" should set an upper limit of the volume of Regulation D offers. *Id.* at 3, 7. However, issuers can choose "Indefinite" instead of specifying an offering amount, an option often chosen by private investment pools such as hedge funds. *Id.* Issuers who do specify a "total offering amount" must amend the Form D filing if the number increases by more than 10%. 17 C.F.R. § 230.503(a)(3)(ii)(C), (E). The "total amount sold at the time of filing" figures sets a floor on the Regulation D volume numbers but may not accurately measure the actual dollar total as no amendments are required if this number changes, and issuers may file the Form D before any sales actually take place. Finally, because Rule 508 provides that the exemption will not be lost for an "insignificant" deviation from the rule, including failing to file the Form D, 17 C.F.R. § 230.508, some issuers do not file a Form D or they fail to amend their filings. The SEC has recently proposed new rules that would require a closing Form D amendment to state the dollar amount of securities actually sold in the offering. Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *supra* note 36. The proposed rule also contemplates an advanced Form D for advertised offerings under Rule 506(c), and it disqualifies issuers who fail to file a Form D form utilizing the Regulation D exemption in future offerings. *Id.*

78. Formerly, this SEC Division was known as the Division of Risk, Strategy, and Financial Innovation. *See* SEC Renames Division Focusing on Economic and Risk Analysis (June 6, 2013), *available at* http://www.sec.gov/news/press/2013/2013-104.htm.

79. *See* 2013 SEC Staff Study, *supra* note 64.

80. *Id.* at 9. This study calculated the total Regulation D dollar volume utilizing the "total amount sold" reports in the Form Ds and the Form D/A amendments. *Id.* at 1. Previously, the Office of the Inspector General estimated the total dollar volume of Regulation D offers in 2008 at $609 billion. *See* OIG 2009 Report, *supra* note 29, at v, 2, 42 (2009). The OIG used a sample of filings in the last quarter of 2008 and calculated volume based upon the "total offering amount." *Id.* at 42.

Regulation D offers also occur with far greater frequency than any other financing vehicle. Table 2 presents data on the number of Regulation D offers from 2009 through 2012 as compared with alternative financing methods:[81]

Table 2. Number of offerings by type of offering and year

Year	Regulation D	Public equity	Public debt	Rule 144A	Reg S	Other 4(a)(2)
2009	20,841	942	1,445	1,240	294	648
2010	29,445	1,072	1,930	1,607	262	668
2011	30,710	863	1,465	1,148	97	863
2012	31,471	954	1,473	1,302	13	518

Among Regulation D offers, the vast majority are conducted pursuant to Rule 506.[82] Tables 3 and 4 show the number and volume of Rule 506 offers during 2011 and 2012. Included in these statistics are offerings from small business entities as well as public companies and private investment pools. Tables 3 and 4[83] break down the offers according to size, with a goal of teasing from the data the presence of retail investors.[84] It is most likely that smaller business entities are represented in the smaller offering ranges and that retail investors are the intended target of such sales.[85]

81. 2013 SEC Staff Study, *supra* note 64, at 9.

82. My review of Form Ds filed in 2011 and 2012 indicates that over 94% of all Regulation Ds and section 4(a)(5) offers were pursuant to the Rule 506 exemption, data consistent with other studies. *See id.* at 7; Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 926 (2011) (finding in a data sample of Form Ds filed from 9/15/2008 to 10/18/2010 that 94% of Regulation D offers are made pursuant to Rule 506). In terms of dollar volume, Rule 506 offers accounted for 99% of all Regulation D offers in 2012. 2013 SEC Staff Study, *supra* note 64, at 11.

83. Tables 3 and 4 were compiled from Form D filings for 2011 and 2012 as tracked by the subscription-based Knowledge Mosaic website: http://www.knowledgemosaic.com/net/sm/formd.aspx. The Form D data in Tables 3 and 4, while the best data available, does not accurately measure all Rule 506 sales. As detailed above, the "Total Offering Amount" column shows the amount issuers hope to raise at the time of the filing and the "Total Amount Sold" column represents only sales completed by the time of filing. *See supra* note 77.

84. In a recent Rule proposal, the SEC is proposing an amendment to Form D to capture this information. *See* Amendments to Regulation D, Form D and Rule 156 Under the Securities Act, *supra note* 36.

85. Institutional investors usually maintain minimum investment parameters. For example, CalPERS ordinarily has a minimum investment size of $50 Million. *General Session Questions & Answers*, CALPERS INVESTMENTS, *available at* www.calpers.ca.gov/index.jsp?bc=/investments/general.xml (last visited Sept. 30, 2013). Similarly, until very recently private equity funds such as Carlyle Group LLP required a minimum investment of between $5 million and $20 million. *See Carlyle Group Cuts Minimum Investment to $50,000 in New Buyout Fund*, REUTERS (Mar. 13, 2013), *available at* http://www.reuters.com/article/2013/03/13/carlylegroup-fund-idUSL3N0C50C720130313.

Table 3: 2011 Rule 506 Offerings

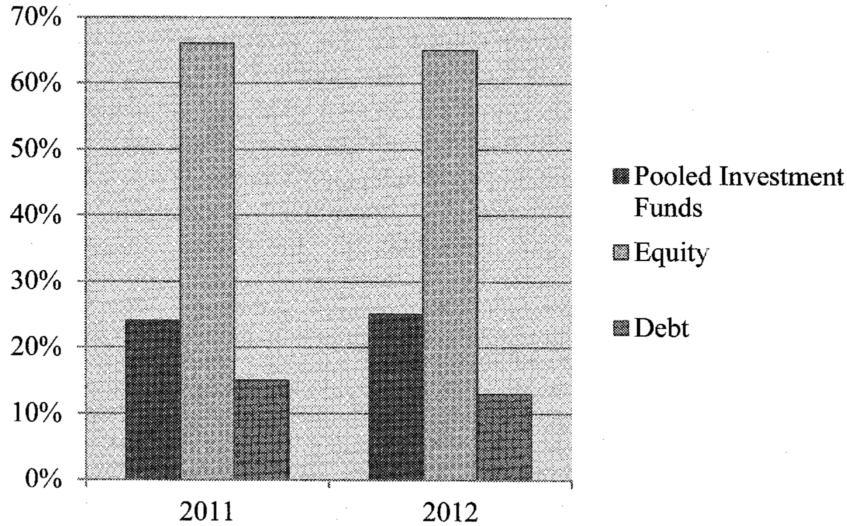
Offering Amount	Number of Offerings	Total Offering Amount (billions)	Total Amount Sold (billions)
$1–$1M	4473	$2.0	$1.1
$1M–$5M	4412	$11.8	$6.7
$5M–$25M	2868	$33.8	$20.5
$25M–$100M	944	$48.8	$26.6
$100M–$500M	522	$130.9	$54.5
$500M–$1B	87	$69.1	$21.8
>$1B	69	$198.0	$16.7
Indefinite	3745	n/a	$251.0
Total	13375	$494.3	$398.9

Table 4: 2012 Rule 506 Offerings

Offering Amount	Number of Offerings	Total Offering Amount (billions)	Total Amount Sold (billions)
$1–$1M	4551	$2.0	$1.1
$1M–$5M	4488	$12.1	$6.8
$5M–$25M	2787	$32.4	$19.6
$25M–$100M	979	$52.1	$27.4
$100M–$500M	451	$118.4	$43.0
$500M–$1B	108	$81.9	$20.5
>$1B	62	$201.1	$201.2
Indefinite	3772	n/a	$250.0
Total	17198	$500.1	$569.2

Table 5 depicts Rule 506 offers by type of security. As shown in Table 5, approximately 25% of the Rule 506 issuers are pooled investment funds such as hedge funds and private equity firms.[86] While institutional investors dominate this space, retail investors comprise over 40% of hedge fund purchasers[87] and private equity firms now have retail investors in their sights.[88]

Table 5: Rule 506 Offers by Type of Security 2011–2012



V. FINRA RULES REGULATING PRIVATE PLACEMENT BROKER/DEALERS

Available evidence suggests that approximately 15% of Rule 506 offerings utilize registered broker/dealers.[89] This equates to

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86. In 2011 and 2012, hedge funds represented approximately 45% of pooled investment fund issuers; private equity funds represented 24%; and venture capital funds approximately 8%. Similarly, the 2013 SEC Staff Study reports that during the period 2009 to 2012, hedge funds were the largest private fund issuers. SEC 2013 Staff Study, *supra* note 64, at 11.

87. *See* Citi Prime Finance, *Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence* 10 (June 2012), *available at* http://citibank.com/transactionservices3/homepage/demo/tutorials41/IIHF_June2012/files/assets/downloads/publication.pdf.

88. Ryan Dezember, *Carlyle Group Lowers Velvet Rope—Offering Allows Some People to Invest as Little as $50,000 With the Giant Private-Equity Firm*, WALL ST. J., Mar. 15, 2013, at C1 (describing private equity firm's push to target retail investors).

89. My review of Form Ds for Rule 506 offers in 2011 and 2012 indicates that the use of broker/dealers ranges from 7% for smaller offerings to 23% for the very largest. Similarly, a FINRA staff review of a sample of 2010 Form D filings found that approximately 15% of Rule 506 issuers disclosed the compensation of a broker/dealer in their Form D. Private Placements of Securities, FINRA Regulatory Notice 11-04, n.7 (Jan. 2011), *available at*

approximately 2,000 Rule 506 placements per year.[90] Until recently, issuers could not advertise or generally solicit investors for Rule 506 offerings. Under SEC staff interpretations, investors could only be approached about a specific investment if they first prequalified as "accredited investors."[91] As I have explained in an earlier paper, the SEC restrictions on general solicitations in Rule 506 offerings had the impact of channeling retail offers through registered broker/dealers due to their preexisting relationships with accredited investors.[92] In 2013, however, the SEC removed the advertising ban, thus allowing issuers to advertise directly to investors if they choose.[93] It will be interesting to see how many issuers take advantage of this new freedom. Given the investor verification requirements in the adopted rule, there is some likelihood that issuers who seek retail investors through advertising will vet their offers and solicitations though an established broker/dealer network that has experience in prescreening investors.[94] In such cases, FINRA will have the responsibility of policing the advertised private placements.[95] Soon, FINRA will take on the added obligation to

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http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf. The 2013 SEC Staff Study reports that intermediaries are used in only 13% of new Regulation D offerings up to $1 million from 2009–2012 and 18% for offerings of more than $50 million. SEC 2013 Staff Study, *supra* note 64, at 17. Professor Campbell, in a study of Form D filings from October 2008 through October 2010, found that 5.8% of issuers raising less than $1 million utilized financial intermediation compared to 12.7% for offers from $1–5 million. Campbell, *supra* note 82, at 931.

90. These statistics lead to an interesting question: if not broker/dealers, who is marketing the majority of private offerings? Some undoubtedly are sold directly by the issuers using available connections in the accredited investor community. Others may enter the market through investment advisor recommendations. Unregistered "finders," however, may market far more private placements. *See, e.g.*, Ranieri Partners LLC & Donald W. Phillips, Release No. 3563, 2013 SEC LEXIS 971 (Mar. 8, 2013) (private equity firm and a partner agreed to $450,000 fine for utilizing unregistered finder and finder agreed to bar from securities industry). NASAA reports that state regulators brought more than 1,500 actions in 2011 and 2012 involving unregistered placement firms or individuals who marketed securities in violation of state laws. N. Am. Secs. Admin'rs Ass'n, *NASAA Enforcement Report* (Oct. 2012), *available at* http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf; N. Am. Secs. Admin'rs Ass'n, *NASAA Enforcement Report* (Oct. 2013), *available at* http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics. As the SEC and state regulators clamp down on unregistered finders, FINRA may witness an increase in registered broker/dealer private placement activity.

91. *See, e.g.*, Use of Electronic Media, Release No. 33-7856, 65 FR 25843, 25851–52 & nn.79–80 (Apr. 28, 2000).

92. *See* Jennifer J. Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993, 1009 (2012). *See also*, Langevoort & Thompson, *supra* note 42.

93. *See supra* notes 33 to 42 and accompanying text.

94. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *supra* note 34 (issuers can rely upon broker/dealer verification of accredited investor status).

95. Broker/dealers who participate in Rule 506(c) advertised offerings are subject to FINRA rules regulating communications with the public. *See* FINRA Rule 2210. Depending upon the content of the solicitation materials, they could constitute a "recommendation," thus also implicating FINRA suitability rules. *See supra* notes 33 to 42 and accompanying text.

regulate broker/dealers who participate in CrowdFunding under Title III of the JOBS Act as well as regulating the non-broker/dealer "Funding Portals."[96] Preliminary evidence suggests that the private placement broker/dealer community will participate vigorously in the CrowdFunding space.[97]

When an issuer employs a broker/dealer to market a private placement, the offering becomes subject to FINRA rules.[98] Recently, the SEC has approved two major rules that implicate broker/dealer participation in private placements: FINRA Rule 2111: Suitability and FINRA Rule 5123: Private Placement of Securities.

A. FINRA Rule 2111: Suitability

FINRA's Rule 2111: Suitability, effective July 9, 2012, requires broker/dealers to undertake three layers of suitability analysis when recommending securities products, including private placements, to retail customers.[99] First, the broker/dealer must investigate whether the product is suitable for any investor, an analysis that FINRA labels "Reasonable Basis Suitability."[100] Next, the broker/dealer must find the product suitable for a particular customer, obligations that FINRA calls "Customer-Specific Suitability" and "Quantitative Suitability."[101] In Regulatory Notices explaining Rule 2111, FINRA states that many obligations imposed by Rule 2111 merely codify FINRA, SEC, and judicial interpretations of pre-existing FINRA rules as well as the antifraud provisions of the federal securities laws.[102] Other provisions

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96. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 302(b), 126 Stat 306, 316 (2012) (codified as amended at 15 U.S.C.A. § 77d-1(a)(2) (West 2013)). Under the CrowdFunding provisions of the JOBS Act, issuers can target nonaccredited investors, but they may not advertise. *Id.* Instead the statute requires the use of intermediaries who are allowed to engage in general solicitation. *Id.*

97. Mohana Ravindranath, *For Broker/Dealers, Crowdfunding Presents New Opportunity: An Exemption in the Securities Act Lets Start-ups Sell Securities to Unlimited Accredited Investors*, WASH. POST (Mar. 28, 2013), http://www.washingtonpost.com/business/on-small-business/for-brokerdealers-crowdfunding-presents-new-opportunity/2013/03/28/bb835942-8075-11e2-8074-b26a871b165a_story.html.

98. FINRA will also regulate the new CrowdFunding portals. *See* Release 33-9470, 2013 SEC LEXIS 3346 (Oct. 23, 2013).

99. *See* Self-Regulatory Organizations, Release No. 63325, 75 FR 71,479, 71,481–82, 71,485 (Nov. 23, 2010) (Order Approving Proposed Rule Change); FINRA Rule 2111.05.

100. 75 Fed. Reg. 71,481; FINRA Rule 2111.05(a).

101. 75 Fed. Reg. 71,481; FINRA Rules 2111(a), 2111.05(b).

102. Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Release No. 34-62718, 2010 SEC LEXIS 2759, at 17, 78–80 (Aug. 20, 2010). Additional Guidance on FINRA's New Suitability Rule, FINRA Regulatory Notice 12-25, 1 (July 9, 2012), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf; New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know

of the Rule, however, impose new or modified responsibilities.[103]

With regard to customer-specific suitability, Rule 2111 expands prior NASD Rule 2310 to provide additional enumerated factors a broker/dealer must review in making the decision of whether an investment is suitable for a particular customer.[104] Under Rule 2111, a broker/dealer must now consider the customer's age, time horizon, liquidity needs, and risk tolerance, in addition to the customer's other investments, financial situation and needs, tax status, and investment objectives as mandated by the previous NASD Rule.[105] Rule 2111 also imposes a requirement that broker/dealers analyze the Quantitative Suitability of an investment for a particular customer.[106] This provision requires broker/dealers who have control over a customer's account to evaluate the customer's entire portfolio in order to have a reasonable basis for concluding that the investment does not involve excessive trading.[107]

Rule 2111 also sets forth an explicit obligation for broker/dealers to engage in a "Reasonable Basis Suitability" analysis, which is an important development for the regulation of private placements. Rule 2111 requires broker/dealers to investigate the issuers and their products to make sure they are legitimate and viable. It also requires the firms to educate their sales representatives so that they also understand the products they recommend to their customers.[108] Rule 2111 codifies FINRA's position that prior FINRA rules and judicial opinions imposed such due diligence requirements upon broker/dealers that sell private placements. Previously, FINRA grounded this due diligence obligation in its interpretations of FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent practices.[109] FINRA also asserted that

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Your Customer and Suitability, FINRA Regulatory Notice 11-25, 2 (July 9, 2012), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_11-25.pdf.

103. FINRA Regulatory Notice 12-25, *supra* note 102, at 1–2; FINRA Regulatory Notice 11-25, *supra* note102, at 2.

104. FINRA Rule 2111(a). *See* FINRA Regulatory Notice 11-25, *supra* note 102, at 3–5; *see generally* FINRA Regulatory Notice 12-25, *supra* note 102.

105. FINRA Rule 2111(a).

106. FINRA Rule 2111.05(c).

107. *Id.* In Regulatory Notice 12-25, FINRA explains that the quantitative suitability obligation merely clarifies the excessive trading (churning) line of cases under the prior rule. *Supra* note 102.

108. In Regulatory Notice 12-25, FINRA states that both the broker/dealer and the associated brokers must understand the product they are recommending. FINRA Regulatory Notice 12-25, *supra* note 102, at 14.

109. *See, e.g.*, Regulation D Offerings: Obligation of Broker–Dealers to Conduct Reasonable Investigations in Regulation D Offerings, FINRA Regulatory Notice 10-22, 3–5 (Apr. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf. FINRA also reminded broker/dealers that they could not meet their requirement under then NASD Rule for customer-specific suitability if they did not understand the product they were recommending. *See*

under applicable SEC and judicial precedents, broker/dealers who recommend a product implicitly represent to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[110] Under this so called "shingle theory," failure to comply with this due diligence obligation could constitute a violation of the antifraud rules of the federal securities statutes.[111] Similarly, FINRA promulgated several regulatory notices involving broker/dealer due diligence obligations for particular products such as tenancies in common and hedge funds.[112]

While the requirements embodied in FINRA Rule 2111 may not break entirely new ground, the rule clearly imposes a more concrete test of broker/dealer due diligence. The prior underpinnings of the product due diligence obligation were vague and scattered among FINRA interpretations of its general fair practice rules and older judicial decisions.[113] The precise origins of the obligation proved difficult to explain to hearing officers even in regulatory proceedings, and private plaintiffs often failed to convince federal courts that a broker/dealer's negligent failure to conduct adequate due diligence constituted fraud.[114]

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also Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments, NASD Notice to Members 03-71, 766–77 (Nov. 2003), *available at* http://www.complinet.com/file_store/pdf/rulebooks/nasd_0371.pdf.

110. Hanly v. SEC, 415 F.2d 589, 597 (2d. Cir. 1969); *see also* SEC. v. Current Fin. Servs., Inc., 100 F. Supp. 2d 1, 7 (D.D.C. 2000); SEC. v. Great Lake Equities Co., No. 89-CV-70601-DT, 1990 U.S. Dist. LEXIS 19819, at *16–17 (E.D. Mich. Sept. 4, 1990); SEC. v. N. Am. Research & Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970).

111. Securities Act of 1933, P.L. 112-106, ch. 38, § 17(a), 48 Stat. 74, 84 (codified as amended at 15 U.S.C.A. § 77q(a) (West 2013)); 17 C.F.R. § 240.10b-5 (2010).

112. *See, e.g.*, Private Placements of Tenants-In-Common Interests, NASD Notice to Members 05-18, 1, 4–5 (Mar. 2005), *available at* http://www.complinet.com/file_store/pdf/rulebooks/nasd_0518.pdf; Complex Products: Heightened Supervision of Complex Products, FINRA Regulatory Notice 12-03, 1–2 (Jan. 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf (listing "structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities"); New Products: NASD Recommends Best Practices for Reviewing New Products, NASD Notice to Members 05-26, 3 (Apr. 2005), *available at* http://www.complinet.com/file_store/pdf/rulebooks/nasd_0526.pdf.

113. In previously justifying its due diligence obligation, FINRA frequently cited the case of *Hanly*, 415 F.2d 589 (2d Cir. 1969), in which the Second Circuit held that the negligent failure of a broker/dealer to conduct adequate product due diligence constituted a violation of Rule 10b-5. *Id.* at 597. *Hanly*, however, predated the U.S. Court's decisions in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212–14 (1976), and *Aaron v. SEC*, 446 U.S. 680, 691 (1980), establishing a scienter culpability standard for both private and governmental actions under Rule 10b-5. *Hanly*, 415 F.2d 589.

114. *See, e.g.*, BNP Paribas Mortg. Corp. v. Bank of Am., N.A., 866 F. Supp. 2d 257, 267 (S.D.N.Y. 2012) ("[M]ere negligent violations of [FINRA] rules are not actionable in federal court; rather, to form the basis for liability in damages, the broker's violations of the rules must be 'tantamount to fraud.'"); Brown v. J.P. Turner & Co., No. 1:09-cv-2649-JEC, 2011 WL 1882522, at *4 (N.D. Ga. May 17, 2011) (broker had no duty to verify information in private placement memorandum); *In re* Enron Corp. Secs., Derivative & "ERISA" Litig., 761 F. Supp. 2d 504, 572–73 (S.D. Tex. 2011) (underwriter in a private placement had no duty to conduct "due diligence" or investigate the issuer or

Rule 2111 clearly establishes broker/dealers' duties and at least provides regulators with a clear rule to interpret. Moreover, it establishes the industry standard of care against which aggrieved investors can measure negligence in FINRA arbitrations. In the rare judicial proceeding, however, investors may still face great difficulties in parlaying a negligent violation of the FINRA due diligence rule into a cause of action cognizable by federal courts.[115]

B. FINRA Rule 5123: Private Placements of Securities

FINRA's new Rule 5123, effective December 3, 2012, applies when FINRA members participate in nonproprietary private placements.[116] Rule 5123 requires broker/dealers to file with FINRA copies of the private placement memoranda (PPMs), term sheets, and any other disclosure documents within 15 days after first sale.[117] The rule exempts private placements sold solely to institutional purchasers and other accredited investors who are not natural persons.[118] Rule 5123 is a notice filing which will not result in FINRA comments or approvals.[119]

Rule 5123 is a pullback from an earlier FINRA rule proposal that would have expanded existing FINRA Rule 5122 to include all broker/dealer private placement activity.[120] Specifically, Rule 5122

the offering). *C.f.* SEC v. Platinum Inv. Corp., No. 02 Civ. 6093(JSR), 2006 WL 2707319, at *3–5 (S.D.N.Y. Sept. 20, 2006) (summary judgment against broker on securities fraud claim where broker recklessly failed to conduct adequate due diligence).

115. *See generally* Barbara Black, *Transforming Rhetoric into Reality: A Federal Remedy for Negligent Brokerage Advice*, 8 TRANSACTIONS: TENN. J. BUS. L. 101 (2006) (explaining that brokerage customers have no federal remedy for incompetent or careless investment advice).

116. A "non-proprietary private placement" refers to an offering in which the broker/dealer is not itself the issuer of the securities or a controlled affiliate of the issuer. *See* Notice of Filing and Accelerated Approval of FINRA Rule 5123, SEC Release 34-67157 (June 7, 2012), *available at* http://www.sec.gov/rules/sro/finra/2012/34-67157.pdf.

117. FINRA Rule 5123(a). On June 25, 2013, FINRA filed with the SEC a proposed rule change that would expand the scope of the required filing to include additional information if known by the broker/dealer. *See* Proposed Rule Change Relating to Members' Filing Obligations Under FINRA Rule 5123, Private Placements of Securities, (June 20, 2013) [hereinafter Proposed Rule Change], *available at* http://www.finra.org/Industry/Regulation/RuleFilings/2013/P285315.

118. FINRA Rule 5123(b). There is no exemption from Rule 5123 for private placements to accredited investors who are natural persons. In recent guidance, FINRA states that CrowdFunding offerings under the JOBS Act are not required to be filed pursuant to Rule 5123. FINRA, Sale of Private Placements Frequently Asked Questions (FAQ), http://www.finra.org/Industry/Compliance/RegulatoryFilings/PrivatePlacements/faq/#3-2.

119. Private Placements of Securities: SEC Approves New FINRA Rule 5123 Regarding Private Placements of Securities, FINRA Regulatory Notice 12-40, 2 (Sept. 2012), *available at* http://www.finra.org/Industry/Regulation/Notices/2012/P163710.

120. *See* Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities, 9 (Oct. 4, 2011), http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p124598.pdf; FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm

requires broker/dealers who participate in proprietary private placements to make affirmative disclosures to investors of the intended use of offering proceeds, expenses, and the amount of selling compensation to be paid.[121] In addition, Rule 5122 requires that at least 85 percent of the offering proceeds be utilized for the business purposes identified in the offering document.[122] Like Rule 5123, Rule 5122 contains a filing requirement to enable FINRA to conduct post sale reviews.[123] FINRA's proposal to expand Rule 5122 to include nonproprietary private placements met with heavy industry resistance,[124] and as adopted, Rule 5122 only applies to proprietary private placements in which the broker/dealer, or a controlling entity, serves as the issuer of the securities.[125]

Rule 5123, while not containing the affirmative disclosure requirements and expense limitations initially proposed by FINRA, is a move forward nonetheless.[126] For the first time, there will be a repository of private placement disclosure documents in the hands of a regulatory body.[127] The Rule provides that FINRA will give confidential treatment to all filed documents and information and that FINRA will use such documents and information "solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA."[128] FINRA has stated that the filings will enable it to provide additional regulatory oversight of brokers who sell private placements.[129] Informally, FINRA has stated that its staff will review

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Participation in Private Placements, FINRA Regulatory Notice 11-04, 4–5 (Jan. 2011), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_11-04.pdf.

121. FINRA Rule 5122(b)(1)(A). Rule 5122 governs FINRA members that issue their own securities in a Private Placement including sales by controlled entities such as pooled investment funds that utilize a captive broker/dealer.

122. FINRA Rule 5122(b)(3).

123. *See* FINRA Rule 5122(b)(2).

124. *See, e.g.*, Bruce Kelly, *Securities firms fight commission cap for private placements*, INVESTMENT NEWS (Mar. 20, 2011), http://www.investmentnews.com/article/20110320/REG/303209977.

125. FINRA Rule 5122(a)(1), (b).

126. On June 20, 2103, FINRA filed immediately effective amendments to Rule 5123 that require broker/dealers to e-file the required documents though its Gateway system and to answer a series of additional questions about the private placement in connection with the filing. Proposed Rule Change, *supra* note 117.

127. Form Ds, the only previous source of private placement filings, do not currently contain these disclosures. On July 10, 2013, the SEC proposed amendments to Form D that would solicit additional information including the intended use of proceeds from all Rule 506 issuers, *see* Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *supra* note 36, but these proposed amendments fall far short of a requirement to file the PPM.

128. FINRA Rule 5123.

129. Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, Release 34-66203 (June 7, 2012); Stan Macel, Assistant General Counsel, FINRA,

the Rule 5123 filings to find trends in private placement sales. The filings may provide early warnings and FINRA staff will contact broker/dealers if something seems amiss. In particular, FINRA intends to review the filings to "identify and assess higher risk transactions"[130] and ascertain if broker/dealers have complied with their reasonable basis suitability obligations under Rule 2111.[131]

At present, it is unlikely that FINRA has adequate staffing to review all of the private placement material that will be submitted under Rule 5123. Even in the short term, however, FINRA should have the ability to spot-check the e-filed materials, and FINRA's examination staff is likely to review materials prior to compliance inspections and when investigating compliance complaints.[132]

VI. FINRA ENFORCEMENT STATISTICS

Of course, rules and good intentions will be effective only when coupled with adequate enforcement.[133] FINRA has announced that the policing of broker/dealer private placement sales practices will be a regulatory priority for 2013.[134] Unfortunately, FINRA's enforcement record to date has been inconsistent at best.

Response to Additional Comments, 2 (May 18, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p126433.pdf.

130. FINRA, Annual Regulatory and Examination Priorities Letter, 4 (Jan. 11, 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

131. Stan Macel, Assistant General Counsel, FINRA, Response to Comments, 13–14 (Jan. 19, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p125430.pdf; Thomas M. Selman, Executive Vice President, Regulatory Policy, Investment Program Association Fall Conference (Nov. 15, 2012), *available at* http://www.finra.org/Newsroom/Speeches/Selman/P197043.

132. Macel, *supra* note 129, at 13–14. While FINRA does not control most private placement issuers, it can make referrals to the SEC or state regulators. Unfortunately the SRO's record of cooperation has been spotty. Some suggest FINRA fears treatment as a governmental agency if it engages too heavily with state and federal regulators. *See, e.g.*, Steven Irwin et al., *Self-Regulation of the American Retail Securities Markets—An Oxymoron for What is Best for Investors?*, 14 U. PA. J. BUS. L. 1055, 1067–71 (2012).

133. *See supra* note 16 (describing the SEC's more limited enforcement activity with respect to broker/dealers).

134. Annual Regulatory and Examination Priorities Letter, *supra* note 130.

Table 5: FINRA Private Placement Enforcement Statistics

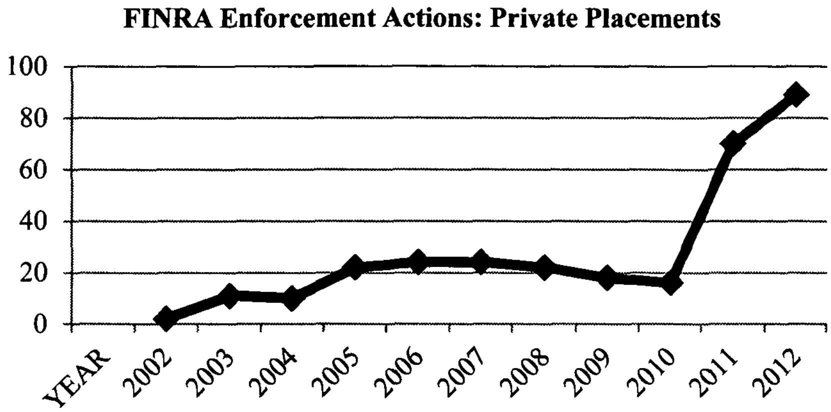

Table 5 details FINRA enforcement actions against broker/dealers who engage in private placement sales.[135] Table 5 clearly demonstrates that until very recently, FINRA's enforcement of the securities laws, and its own private placement rules, has been abysmal. For most of the past decade, FINRA brought very few enforcements actions against broker/dealers based upon private placement activity. Only after the public exposure of large-scale private placement frauds in 2010 and 2011 did FINRA bring enforcement proceedings in any meaningful numbers.[136] Massive losses occasioned by broker-facilitated fraudulent offerings in Medical Capital, DBSI, and Provident Royalties[137] resulted in criminal indictments against the principal of the issuers;[138] federal

135. Table 5 counts an enforcement proceeding against both a broker/dealer firm and one or more associated representatives as one enforcement action.

136. FINRA reports that in 2011, it received 1,100 customer complaints and opened 250 investigations resulting in 70 enforcement actions against private placement broker/dealers. Macel, *supra* note 129, at 10. My research shows that at least 10 of the enforcement actions resulted from the large-scale Ponzi schemes while another 10 involved selling away cases.

137. Medical Capital Holdings, DBSI, Inc. and Provident Royalties LLC were large syndicators of private placement offerings that were little more than Ponzi schemes. Investors lost in excess of a billion dollars in these phony investments. For an in depth description of these fraudulent sales, *see generally* Johnson, *supra* note 92.

138. In May 2012, former Medical Capital president Joseph J. Lampariello pled guilty to wire fraud. *See* Ronald Campbell, *President of 'Ponzi-like' Fraud MedCap Pleads Guilty, OC Register*, ORANGE COUNTY REG. (May 7, 2012, 9:59 PM), *available at* http://www.ocregister.com/articles/medcap-353057-lampariello-million.html. In November 2012, Paul Melbye, cofounder and former chief executive of Provident Royalties, pled guilty to conspiracy to defraud investors in connection with a $485 million oil and gas promotion. Laurel Brubaker Calkins, *Ex-Provident Royalties CEO Admits Guilt in $485 Million Scam*, BLOOMBERG.COM (Nov. 9, 2012, 3:48 PM), http://www.bloomberg.com/news/2012-11-09/ex-provident-royalties-ceo-admits-guilt-in-485-million-scam-1-.html. Other Provident officers recently received prisons terms in connection with the failed private placements. Bruce Kelley, *Bosses of Broker-Breaker Provident Royalties Get Prison Time*, INVESTMENT NEWS (July 11, 2013), *available at*

regulatory proceedings against the issuers;[139] state regulatory actions against broker/dealer firms;[140] class actions;[141] and a multitude of FINRA arbitrations.[142] In light of the apparent pervasiveness of broker/dealer participation in these schemes, FINRA could no longer ignore the problem.

FINRA states that the regulation of broker/dealers who sell private offerings and other complex products to retail investors will be a regulatory priority for the SRO.[143] It remains to be seen if FINRA will carry out its announced agenda through its enforcement actions.[144]

VII. CONCLUSION

This Article has presented data demonstrating that private securities offerings now dominate all modes of capital formation in the United States. The new SEC Rule 506(c), permitting advertised private offers, may further increase the number and volume of these offerings. There will be increased pressure on broker/dealers to verify accredited investor status[145] and to conduct an appropriate suitability analysis for investors

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http://www.investmentnews.com/article/20130711/FREE/130719976. In April 2013, an Idaho grand jury indicted the principals of DBSI. Bruce Kelly, *Officers at Big Three Private Placement Shop Indicted: Four Executives at DBSI Charged with, Among Other Things, Securities Fraud*, INVESTMENT NEWS (Apr. 11, 2013, 3:24 PM), *available at* http://www.investmentnews.com/article/20130411/FREE/130419978.

139. The Securities and Exchange Commission sued Medical Capital and Provident Royalties, LLC for fraud in 2009. *See* Second Amended Complaint for Violations of the Federal Securities Laws at 7–24, SEC v. Med. Capital Holdings, Inc., No. SACV 09-818 DOC (RNBx), 2010 WL 809406 (C.D. Cal. Mar. 16, 2010); SEC v Provident Royalties LLC. Litigation Release No. 21118, 2009 SEC LEXIS 2241 (July 7, 2009).

140. A few state regulators brought enforcement actions against broker/dealers that sold the failed private placements. *See, e.g.*, Administrative Complaint at 1, *In re* Secs. Am., No. 2009-0085 (Mass. Sec'y of the Commonwealth, Sec. Div. Jan. 26, 2010), *available at* http://www.sec.state.ma.us/sct/archived/sctsa/sa_complaint.pdf.

141. *See, e.g.*, Billitteri v. Secs. Am., Inc., Nos. 3:09-cv-01568-F, 3:10-cv-01833-F, 2011 WL 3586217, at *1–2 (N.D. Tex. Aug. 4, 2011) ($80 million class action settlement on behalf of Securities America customers who purchased private placement investments in Medical Capital Notes and Provident Royalties).

142. *Id.* at *2 (explaining $70 million settlement to members of a class of investors who had purchased Provident and Medical Capital securities through a Securities America broker/dealer and who had opted to participate in FINRA arbitration).

143. Annual Regulatory and Examination Priorities Letter, *supra* note 130. Similarly, the SEC had indicated that it will carefully review broker/dealer sales practices impacting retail investors. SEC, OCIE National Exam Program, Examination Priorities for 2013, at 7 (Feb. 21, 2013), http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

144. At least one skeptic doubts that FINRA's actions will match its rhetoric. *See* Bill Singer, *FINRA CEO Ketchum's Speech and the Shortcomings of Self Regulation*, FORBES (Mar. 15, 2013, 10:12 AM), *available at* http://www.forbes.com/sites/billsinger/2013/03/15/finra-ceo-ketchums-speech-and-the-shortcomings-of-self-regulation ("[FINRA's] track record doesn't exactly overwhelm me with a sense of pre-emptive market intervention or of timely enforcement.").

145. Under Rule 506(c) an issuer is deemed to have taken reasonable steps to determine an

who learn of private deals online or through other advertising venues. While private placements sales are currently restricted to defined accredited investors, recent CrowdFunding initiatives will open a portion of this market to all investors regardless of wealth. On the one hand, these new advertised ventures can provide ample opportunities for increased fraud.[146] On the other hand, the advertising materials, private placement FINRA filings, and required CrowdFunding disclosures will provide enforcement opportunities as well, albeit not in time to prevent most investor losses. As FINRA recognizes in its 2013 regulatory and examination priorities,[147] the SRO will be right in the middle of this sea change.

In regulating broker/dealers who participate in private placements (as well as its role in policing CrowdFunding intermediaries), FINRA cannot remain asleep at the wheel like it has in years past.[148] The SRO will have to decide whether to bow to industry pressure or to legislate and enforce, with investor protection as a primary goal. There is little doubt that FINRA is now awake, but given its checkered enforcement history with private placements, the SRO needs to take its increased role very seriously in this brave new world of advertised offers and retail investors.

individual investor's accredited status if a broker/dealer confirms that it has taken reasonable steps to verify that status.

146. In adopting Rule 506(c) permitting advertised private offerings, the SEC recognized the potential for increased fraud. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *supra* note 34, at 7–8 ("[W]e recognize the concerns raised by a number of commenters that a general solicitation for a Rule 506(c) offering would attract both accredited and non-accredited investors and could result in an increase in fraudulent activity in the Rule 506 market, as well as an increase in unlawful sales of securities to non-accredited investors."). SEC Commissioner Aguilar, dissenting from the adoption of Rule 506(c), similarly noted the increased opportunities for fraud and chided the Commission for adopting the new Rule without mitigating measures in place. Commissioner Luis A. Aguilar, *Facilitating General Solicitation at the Expense of Investors*, U.S. Securities and Exchange Commission, Open Meeting Washington, D.C. (July 10, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539684712#.Ulym8ZvD9Ms.

147. *See* Annual Regulatory and Examination Priorities Letter, *supra* note 130, at 4.

148. FINRA is already under industry pressure to "go light" with its CrowdFunding rules.