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Mad Money: Rethinking Private Placements

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Mad Money: Rethinking Private Placements

Abraham J.B. Cable*

Abstract

Currently, regulations try to limit unregistered sales of stock (private placements) to the "smart money," either by informing investors through disclosure or excluding unsophisticated investors from the market. In theory, these smart-money approaches promote the dual goals of capital formation and investor protection. But in practice, regulators have struggled to craft effective disclosure or screening mechanisms. In light of these failures, this Article advocates for a new approach—investment caps that allow every investor a limited amount of "mad money" to invest in risky private placements. This mad-money approach can protect investors by encouraging basic diversification and liquidity, while advancing capital formation at least as well as alternatives.

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I. Introduction

When President Obama signed the Jumpstart Our Business Startups Act (JOBS Act) into law, he deemed it a potential "game changer."[1] Specifically, he commended the law for nurturing the next Facebook or Apple by easing restrictions on unregistered sales of stock, referred to as private placements.[2] But bold predictions and plucky name aside, the law is mostly a continuation of stale approaches to regulating private placements. True, startup companies can now sell stock through third-party "crowdfunding" sites modeled after Kickstarter, but only after providing prescribed and costly information to investors.[3] True, a startup company can now solicit investors

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1. *Remarks by the President at JOBS Act Bill Signing*, WHITE HOUSE, http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing (last visited Nov. 19, 2014) (on file with the Washington and Lee Law Review).

2. *See id.*

> And who knows, maybe one of them or one of the folks in the audience here today will be the next Bill Gates or Steve Jobs or Mark Zuckerberg. And one of them may be the next entrepreneur to turn a big idea into an entire new industry. That's the promise of America. That's what this country is all about.

3. *See* Jumpstart Our Business Startups Act (JOBS Act) § 302, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.) (creating a new crowdfunding exemption). Prior to the JOBS Act, crowdfunding sites were limited to charitable purposes or advanced product sales, out of concern that sale of stock would violate securities laws. *See* Benjamin P. Siegel, *Title III of the JOBS Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 781–88 (2013) (describing legal impediments to crowdfunding prior to the JOBS Act); *see generally* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 (2012) (providing an overview of crowdfunding practices and proposals prior to the JOBS Act). For critiques of the JOBS Act crowdfunding exemption, see Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741–44 (2012) (emphasizing the importance of disclosure

through its own website, but only if it limits sales to wealthy investors deemed capable of making sound financial decisions.[4] Like prior law, the JOBS Act primarily tries to protect investors by creating (through disclosure) and identifying (through investor qualification standards) the "smart money."[5]

Congress's decision to double down on these smart-money approaches is puzzling. Regulators have struggled to identify information that investors actually value, as evidenced by disuse of exemptions conditioned on specified disclosure.[6] Moreover, it is at best questionable whether wealth standards are a reasonable measure of investment capabilities—for example, a successful dentist may know little about hedge funds.[7] For the JOBS Act, the unfortunate implications are that: (1) issuers and investors will steer clear of the crowdfunding exemption because of its rigid disclosure requirements, and (2) the JOBS Act's liberalized rules

requirements in crowdfunding exemptions); Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments That Begs for a Happy Ending*, 102 KY. L.J. 865, 867–68 (2014) (criticizing Congress's role in setting parameters of the crowdfunding exemption); Siegel, *supra*, at 781, 799–807 (critiquing the JOBS Act crowdfunding provisions and proposing "a workable solution that properly balances the goals of the federal securities laws—the facilitation of capital formation through transparent securities offerings and the deterrence of investor fraud"); James J. Williamson, *The JOBS Act and Middle-Income Investors: Why It Doesn't Go Far Enough*, 122 YALE L.J. 2069 (2013) (arguing that the crowdfunding exemption should be more accessible to investors who are not affluent).

4. Prior to the JOBS Act, sales through an issuer's website or other public forums violated the "ban on general solicitation." *See* Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 134 (2011) (providing an overview of the "ban on general solicitation" before the implementation of the JOBS Act); William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1 (2004). The JOBS Act eliminated the ban, provided all investors meet wealth standards set forth in the accredited investor definition. 15 U.S.C. § 77d (2012).

5. Investopedia defines smart money as "[c]ash invested or wagered by those considered to be experienced, well-informed, 'in-the-know' or all three." *Smart Money,* INVESTOPEDIA, http://www.investopedia.com/terms/s/smart-money.asp (last visited Nov. 19, 2014) (on file with the Washington and Lee Law Review).

6. *See infra* notes 155–56 and accompanying text.

7. *See infra* note 158 and accompanying text.

for sales to accredited investors leave wealthy but unsophisticated investors unprotected.[8]

But despite the JOBS Act's broader failures,[9] this Article finds something redeeming in one of the law's more obscure provisions. Buried deep in the new crowdfunding exemption is a building block for future exemptions—an "investment cap" limiting the amount any single purchaser can invest.[10] For example, an investor with a net worth of $250,000 can invest no more than $25,000 in crowdfunding offerings annually.[11] In contrast to smart-money approaches, an investment cap assumes that many individual investments will fail and simply tries to mitigate the effects of such losses by preventing a small number of private placements from dominating any single investor's portfolio. In other words, each investor is allowed a limited amount of "mad money"[12] for presumably risky private placement

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8. *See, e.g.*, William K. Sjostrom, *Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143, 1143 (2013)

> Based on more than a decade of following, researching, and writing about private placement regulation, I fear that the latest round of capital formation enhancements has tilted the balance too far in favor of capital formation and away from investor protection, especially given the size of the private placement market today.

9. For a general overview of the JOBS Act and its shortcomings, see Michael D. Guttentag, *Protection From What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 234 (2013) ("[T]he JOBS Act was notable both for the speed with which it was enacted and the limited consideration of its potential impact.").

10. *See* 15 U.S.C. § 77d(a)(6)(B) (2012) (imposing limits on the amount a particular issuer can sell to a particular investor in a crowdfunding transaction); 15 U.S.C. § 77d-1(a)(8) (2012) (requiring crowdfunding intermediaries to enforce an aggregate investment cap taking into account all crowdfunding purchases across all issuers). It is not obvious from the language of the JOBS Act that it imposes both a per-issuer and aggregate investment cap. *See* Comment Letter from Michael Doud Gill III to the SEC (Jan. 22, 2014), SEC File No. S7-09-13 (discussing ambiguity in the statute) (on file with the Washington and Lee Law Review). But commentators interpret it in this manner. *See, e.g.*, C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L. J. 194, 200–01 (identifying the per-issuer and aggregate investment limits).

11. *See infra* notes 125–27 and accompanying text (explaining calculation of the investment cap). The example assumes that the investor's annual income does not exceed $250,000 annually.

12. Wiktionary defines mad money as "[a] sum of money, often relatively small in amount, kept in reserve to use for impulsive, frivolous purposes." *Mad Money,* WIKTIONARY, http://en.wiktionary.org/wiki/mad_money (last visited Nov.

investments, similar to asset-allocation strategies promoted by professional investment advisors.[13] Despite their inauspicious introduction to federal securities law through the mostly flawed JOBS Act, this Article argues that investment caps should play a far larger role than they currently do in private placement regulation.

Beyond any single reform proposal, it is worthwhile to think through investment caps because the exercise requires one to confront a surprising gap in legal scholarship. The dominant theoretical perspective for evaluating the JOBS Act and other private placement regulations is to seek an elusive "balance" between capital formation and investor protection.[14] But to say that Congress and the SEC should balance investor protection and capital formation raises more questions than it answers. What do we mean by investor protection and why does it necessarily need to be balanced against, rather than harmonized with, capital formation?[15] Once defined, which mechanisms for regulating private placements best further the relevant goals? Private placement regulation, it seems, is in need of first-principles analysis. Although legal scholars have written comprehensively on the theoretical basis for mandatory disclosure for companies undertaking a registered offering,[16] legal

19, 2014) (on file with the Washington and Lee Law Review).

13. *See infra* note 207 and accompanying text (discussing conventional investment advice).

14. *See, e.g.*, Hazen, *supra* note 3, at 1738 ("Policymakers continually face the challenge of effectively balancing the benefits of encouraging small business formation against the investor protection goals of the securities laws."); Sjostrom, *supra* note 8, at 1143 ("Regulating securities entails balancing investor protection and capital formation."); 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, 920 (2011) ("[S]ensible and successful exemptions from the registration requirements of the Securities Act must strike an acceptable balance between investor protection and capital formation."); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified*, 47 OKLA. L. REV. 291, 302 (1994) (noting "tension" between capital formation and investor protection).

15. Michael Guttentag recently made important inroads addressing this question after noting that the concept of investor protection is surprisingly under-theorized. Guttentag, *supra* note 9, at 209.

16. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1031 (2009) (suggesting that the economic argument for mandatory disclosure "was probably

scholarship is surprisingly sparse on fundamental policy issues affecting a private placement market that currently exceeds a trillion dollars annually.[17] In analyzing investment caps, this Article frames and begins to address these important issues.

This Article has four parts. Part II puts investment caps in context by describing the basic structure and goals of federal securities regulation with emphasis on the goals of capital formation and investor protection. Investor protection in particular proves to be a slippery concept.[18] Securities law, including but not limited to private placement regulation, reflects multiple notions of investor protection. At times, various notions of investor protection are in conflict with each other and with the goal of capital formation.

Part III focuses in on the rationale for, and mechanics of, current private placement exemptions. It describes the smart-money approaches of: (1) scaled-disclosure to investors,[19] and (2) sorting capable and incapable investors.[20] It contrasts these ubiquitous approaches to the less common approach of containing the damage of failed investments through investment caps and similar mechanisms.[21]

Part IV argues that investment caps should play a bigger role in private placement regulation. The argument focuses on the challenges of regulating the wide range of investment products sold in private placements. For example, scaled-disclosure mechanisms are appealing if we are confident in regulators' ability to identify information that is useful across a wide range of investment products and to a wide range of investors. But, in fact, investors do not rely on the same type of information across investment products.[22] Similarly, there is a

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the most important topic in securities regulation scholarship during the 1980s and '90s").

17. *See* Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 689 (2008) (describing the size of the market for private placements).

18. *See infra* notes 41–43 (discussing the unclear meaning of investor protection).

19. *Infra* Part III.B.1.

20. *Infra* Part III.B.2.

21. *See infra* Part III.B.3 (describing the distinctive logic of investor caps and other portfolio mechanisms).

22. *See infra* Part IV.B.1 (discussing the failure of scaled disclosure).

strong case for sorting mechanisms if regulators can distinguish capable from incapable investors. But regulators have understandably struggled to find an accurate proxy for investor capabilities that applies across investment contexts.[23] (An investor may be capable with respect to a real estate partnership but not a high-tech startup.) Investment caps, in contrast, may function better with incomplete information about investment contexts.[24] A cap can achieve at least some beneficial diversification and liquidity without extensive information about the issuer or the purchaser.[25]

Part V lays out a proposal for making investment caps the centerpiece of private placement regulation, and addresses likely objections. Under the proposal, an exemption relying primarily on investment caps would replace current Regulation D as the primary mechanism for moderately sized private placement offerings to individual investors, as opposed to institutional investors. Although others have recently recommended an increased role for investment caps, this proposal goes further in replacing much of the current regulatory apparatus.[26]

II. The Structure and Goals of Securities Regulation

Evaluating the new regulatory tool of investment caps requires an understanding of their role in the broader context of securities regulation and an understanding of the relevant policy goals. Accordingly, this Part provides a brief overview of the structure of securities regulation and tries to answer the surprisingly difficult question of what this regulatory scheme is designed to achieve.

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23. *See infra* Part IV.B.2 (discussing the failure of sorting).

24. *See infra* Part IV.C (discussing how investment caps are affected by regulatory challenges).

25. *See infra* Part IV.C (discussing the benefits of investment caps).

26. *See infra* Part V.C (discussing investment caps proposed by legal scholars and an advisory committee established by the Securities and Exchange Commission).

A. Basic Elements of Federal Securities Regulation

Federal securities laws are primarily set out in the Securities Act of 1933 (the '33 Act)[27] and the Securities Exchange Act of 1934 (the '34 Act),[28] and related regulations promulgated by the Securities and Exchange Commission (the SEC). These laws apply to a broad range of investment products, including stock, stock options, bonds, and more esoteric schemes in which purchasers hope to profit primarily from the efforts of others.[29]

The regulatory scheme has three primary features. A prohibition on fraud provides purchasers with remedies, and empowers regulators to impose sanctions, if issuers make false statements while selling securities.[30] In addition, individuals and firms with regular involvement in securities transactions, such as broker–dealers and investment advisers (referred to as "securities professionals"), are subject to various licensing requirements and have special duties to clients.[31] Finally, and most central to this Article, any company selling securities must register the sales with the SEC and provide investors with extensive disclosure at the time of sale and on an ongoing basis (referred to as "mandatory disclosure"), unless the transaction qualifies for a specific private placement exemption.[32]

Although mandatory disclosure is considered the hallmark feature of federal securities law, a great many transactions are in fact exempt from registration under various private placement exemptions.[33] In fact, registered offerings, such as Twitter's 2013 initial public offering (IPO), are relatively infrequent occurrences

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27. 15 U.S.C. §§ 77a–aa (2012).

28. *Id.* §§ 78a–pp (2012).

29. *See id.* § 77b (defining the term security); SEC v. W.J. Howey Co., 328 U.S. 293, 297–99 (1946) (formulating a test for whether a financial arrangement constitutes an "investment contract" and therefore a security).

30. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 837–45 (4th ed. 2001) (providing an overview of "weapons in the federal antifraud arsenal").

31. *See* Cable, *supra* note 4, at 135–47 (describing the regulation of broker–dealers and investment advisers).

32. *See* 15 U.S.C. § 77e (requiring the registration of securities transactions); *id.* § 78m (requiring periodic disclosures).

33. *See, e.g.*, *infra* notes 100–03 and accompanying text (describing various exemptions from registration requirements).

requiring hundreds of pages of disclosures to investors and millions in fees to lawyers, bankers, and accountants.[34] In the case of smaller transactions, or transactions with a small number of sophisticated investors, issuers and their lawyers expend considerable time and effort assuring themselves that private placement exemptions apply and that full-blown mandatory disclosure is not triggered.[35]

Though private placements are exempt from registration and full-blown mandatory disclosure, they are not exempt from regulation altogether. In addition to the ever-present prohibition on fraud, private placement exemptions are subject to various conditions relating to the offering process, such as requirements to limit sales to accredited investors, make abbreviated disclosures, or make filings with the SEC.[36]

In narrow circumstances, compliance with an investment cap is one of these conditions to exemption. For example, a company availing itself of the new crowdfunding exemption must sell its securities through an SEC-regulated "funding portal," provide purchasers with specified information, and limit the amount each investor purchases in accordance with the investment cap.[37] Currently, investment caps are a relatively minor part of private placement regulation.[38]

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34. *See* Twitter, Inc., Prospectus (Form 424B4) (Nov. 6, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1418091/000119312513431301/d564001 d424b4.htm (last visited Nov. 19, 2014) (providing over 200 pages of disclosures to investors) (on file with the Washington and Lee Law Review); PRICEWATERHOUSECOOPERS, CONSIDERING AN IPO? THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU 5–10, 12–23 (2012), http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf (estimating costs of conducting an IPO and complying with ongoing public company requirements).

35. *See infra* note 36 (describing regulatory requirements of private offering exemptions).

36. *See infra* notes 114–15 and accompanying text (describing the accredited investor concept in Rule 506 offerings); *infra* notes 104–05 and accompanying text (describing exemptions based on informational requirements); 17 C.F.R. § 230.503 (2014) (requiring an issuer to file Form D in connection with certain exemptions).

37. *See* 15 U.S.C. § 77d(a)(6) (2012) (providing a crowdfunding exemption and related investment cap).

38. *See supra* note 10 (discussing operation of the crowdfunding investment cap). In addition to the crowdfunding cap, the SEC recently proposed an investment cap in connection with the new Regulation A+ exemption under the

B. The Goals: Capital Formation and Investor Protection

At one level, the goals of the regulatory apparatus described above are easy to identify. Commentators generally agree that securities laws—including, but not limited to, private placement regulations—should facilitate capital formation and protect investors.[39] These objectives are so well accepted that they are now enshrined in the '33 Act, with Congress instructing the SEC to consider these dual goals in all rulemaking.[40]

Despite broad acceptance of these goals, the meanings of and relationship between investor protection and capital formation are not always clear. In particular, there is no consensus regarding the meaning of investor protection. This is somewhat surprising given the term's historical pedigree and prevalence in law and legal scholarship.[41] As Michael Guttentag states in one of the few law review articles addressing the topic: "A fundamental question about investor protection has been all but ignored: what are the particular harms that securities regulations are designed to protect investors from?"[42] This subpart looks broadly at securities regulation (not only at private placement regulations) to identify philosophies of investor protection and explore their relationship to securities law's other goal of capital formation.[43]

JOBS Act. *Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act*, Securities and Exchange Commission Release No. 33-9497 (Dec. 18, 2013), at 50–53.

39. *See supra* note 14 and accompanying text (discussing the "elusive 'balance' between capital formation and investor protection").

40. *See* 15 U.S.C. § 77b(b) ("[T]he Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

41. *See* Guttentag, *supra* note 9, at 208–09 (identifying investor protection as a central focus of securities laws); Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 181 (2010) ("The SEC has repeatedly called investor protection the 'basic purpose' of the Securities Exchange Act of 1934.").

42. Guttentag, *supra* note 9, at 209.

43. The organization of this section draws from Guttentag's very insightful work but does not follow his analysis precisely. Guttentag divides his discussion of investor protection into five categories: fraud, an unlevel informational playing field, investor mistakes, opportunistic behavior by management (agency costs or "tunneling"), and excessive risk. *Id.* at 233. This Article addresses concerns about an unlevel informational playing field under the concept of populist investor protection and concerns about investor mistakes and excessive risk primarily under the concept of paternalistic investor protection. For

1. Capital Formation

The availability of funding for existing and new businesses contributes to a number of policy goals. For example, proponents of the venture-capital industry claim impressive effects on employment.[44] Access to capital may also be a key driver of innovation and, in turn, economic growth.[45] Because novel businesses are not always good candidates for traditional bank financing, public and private equity markets take on particular importance for innovative companies.[46]

These perceived benefits of capital formation, however, do not fully explain the relationship between capital formation and securities regulation. Given the market-based orientation of U.S. securities laws,[47] legal scholars have expended significant effort

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purposes of this Article's analysis, tunneling and fraud can be subsumed within the single category of investor-choice protection because victims of tunneling or fraud do not get what they bargained for and even those not directly victimized may withdraw from the market and forego otherwise beneficial transactions if tunneling or fraud are prevalent. For a discussion of fraud, see *infra* Parts III.A.1, III.A.2, IV.B.3, and IV.C.

44. *See* Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Startups,* 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 195, 209 (2013) (discussing the job-creation claims of the venture-capital industry).

45. *See* ROBERT COOTER, SOLOMON'S KNOT: HOW LAW CAN END THE POVERTY OF NATIONS 27–38 (2012) (explaining that economic growth requires the difficult task of combining ideas with capital).

46. *See* Cable, *supra* note 4, at 121 (discussing why startup companies struggle to obtain bank financing). Despite the prevalence of capital formation as a policy goal, there is a theoretical question of whether capital formation is always beneficial. The dot-com bubble of the late 1990s and early 2000s, for example, was a time of robust capital formation but is now viewed as a period of "irrational exuberance." BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING 80–98 (2011). To some observers, what matters most from a policy perspective is allocative efficiency—ensuring that the most promising projects receive funding in amounts and at prices that reflect their superior prospects. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 280 (1991). And some observers question whether improving the operation of stock markets in fact has much effect on the allocation of resources in the economy. *See* WILLIAM K. S. WANG & MARC I. STEINBERG, INSIDER TRADING 2.2.2 (3d ed. 2010) (citing sources on both sides of the debate); Lynn Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 618 (1998) (identifying allocative efficiency as a common goal of securities regulation but questioning actual effects of securities regulation on resource allocation).

47. U.S. securities law reflects what Easterbrook and Fischel refer to as a

in considering why regulation is necessary to achieve the goal of capital formation.[48] Much of this scholarship has focused on a central feature of U.S. securities law: mandatory disclosure.[49]

The predominant explanation for a baseline rule of mandatory disclosure is that markets would, if left unregulated, produce less than the optimal amount of disclosure for investors. This argument starts by recognizing that investment transactions are plagued by information asymmetry—entrepreneurs have information that they do not want to communicate to investors or that they have trouble communicating credibly. Information asymmetry impedes otherwise beneficial transactions in several respects. First, it increases agency costs because the information imbalance in favor of the entrepreneur gives him or her more chances to engage in opportunistic behavior.[50] Second, difficulty in verifying information makes purchasers of securities susceptible to fraud (intentional misrepresentation).[51] Finally, information asymmetry leads to a lemons problem. Unable to distinguish good projects from bad, investors are forced to discount all opportunities, the most promising projects are underfunded, and some savvy investors withdraw from the market.[52]

"dominant principle" that "anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain." EASTERBROOK & FISCHEL, *supra* note 46, at 277.

48. *See* Langevoort, *supra* note 16, at 1031 (describing efforts by legal scholars to explain the rationale behind mandatory disclosure).

49. *See infra* notes 50–59 (citing examples from this sizable literature).

50. *See* Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 133–36 (2004) (discussing the relationship between disclosure and agency costs).

51. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 280–81 (discussing how difficulty in verifying information about securities enables misstatements by issuers). Though it seems uncontroversial that information asymmetry increases susceptibility to fraud, it is not as clear that mandatory disclosure is effective in fighting fraud. *See* Michael D. Guttentag et al., *Brandeis' Policeman: Results from a Laboratory Experiment on How to Prevent Corporate Fraud*, 5 J. EMP. LEGAL STUD. 244, 250–52, 273 (2008) (noting the "indirect" and "subtle" relationship between mandatory disclosure and fraud mitigation, and presenting evidence that mandatory disclosure does mitigate fraud).

52. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 280 (explaining the effects of information asymmetry).

The existence of information asymmetry, however, does not quite explain why disclosure should be mandatory. After all, investors can (and often do) demand disclosure on their own, and entrepreneurs can (and often do) provide disclosure voluntarily to encourage investment.[53] Why would a mandatory disclosure system provide information at a level, or of a type, that is superior to this voluntary system?

One problem is that disclosure practices may generate positive externalities. For example, a disclosure system that is standard or uniform across issuers—asking all issuers to disclose the same types of information at the same time—has distinct advantages. Investors can use standardized information to more easily compare competing projects.[54] In addition, a standardized system may avoid duplicative efforts to ascertain relevant information because disclosure standards reflect past learning about which types of information prove effective in evaluating projects.[55] Despite these advantages of standardized disclosure practices, no individual investor is perfectly motivated to bear the costs of creating and enforcing such a system because it potentially creates benefits for other investors, and no individual entrepreneur is perfectly motivated to bear the costs of creating such a system because it may create benefits for competitors.[56]

If the market does not produce standardized disclosure at optimal levels, regulatory action may be warranted.[57] A

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53. *See id*. at 280–83 (discussing how securities markets would operate without legal intervention).

54. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 685–87 (1984) (discussing the benefits of standardized disclosure requirements).

55. *See id.* at 681–82 (discussing duplicative search efforts by investors).

56. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 46, at 290–92, 303 (discussing third-party effects of disclosure); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339–45 (1999) (discussing third-party effects of disclosure); Guttentag, *supra* note 50, at 136–38 (discussing third-party effects of disclosure).

57. Whether the current mandatory disclosure scheme is effectively designed to achieve this goal is the subject of vigorous debate. *See* Guttentag, *supra* note 50, at 169–90 (reviewing a voluminous literature on mandatory disclosure and arguing that the current system requires disclosure of the wrong types of information); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2373–80 (1998) (arguing that an "issuer choice" regime, where issuers could opt into different degrees of

lawmaker could try to address this market failure by: (1) developing and mandating disclosure requirements directly, or (2) delegating the function to a group of professionals. U.S. securities laws are a mix of these approaches. Lawmakers directly specify the nonfinancial information that issuers must disclose before publicly selling securities.[58] For the most part, lawmakers have delegated oversight of financial disclosure to the accounting profession.[59] By requiring issuers to make the disclosures recommended by the accounting profession, and by vesting accountants with the exclusive right to develop the standards, lawmakers create incentives to develop and maintain disclosure standards that might otherwise be under-produced.

In sum, laissez-faire policies may not achieve optimal levels of capital formation. Investment transactions are plagued by information asymmetry, and market actors may have high transactions costs in trying to contract for optimal disclosure. Mandatory disclosure can be understood as an effort to give investors what they would contract for in the absence of those transactions costs.

2. Investor-Choice Protection

One philosophy of investor protection focuses on facilitating mutually beneficial investment transactions by mitigating information asymmetries and the associated problems of fraud, agency costs, and lemons market.[60] Analogizing to other product

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disclosure, would be more effective).

58. *See, e.g.*, 17 C.F.R. § 229 (2014) (mandating disclosure of information about an issuer's business, property, management, and governance); *id.* § 239.11 (requiring this information to be included in the prospectus for an initial public offering).

59. *See, e.g.*, 17 C.F.R. § 239.11 (requiring an issuer to provide investors with financial information in the form required by Regulation S-X under the '33 and '34 Acts); *id.* § 210 (requiring that the financial information be audited by certified public accountants).

60. *See* Bradford, *supra* note 3, at 98 ("The SEC has long seen its mission as 'investor protection in the sense of remedying information asymmetries and rooting out fraud . . . .'" (quoting Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1005)); *supra* notes 50–52 and accompanying text (describing the effects of information asymmetry).

markets,[61] removing these barriers to efficient investment transactions maximizes investors' surplus. I call this policy goal "investor-choice protection" because it focuses on effectuating investor preferences.

In the context of publicly traded companies, this type of protection is achieved through the same mandatory disclosure system that promotes capital formation. This scheme arguably protects investors in the sense of mitigating information asymmetries and enabling investors to buy the securities they want at the price they deem appropriate.[62] For publicly traded stock, the protections extend to even those investors who cannot themselves understand the disclosures, because information is rapidly digested by the market and communicated through price.[63]

Despite frequent claims that investor protection and capital formation need to be balanced—suggesting that they are in tension—the two goals are harmonized under this notion of investor protection. Capital formation and investor-choice protection are two sides of the same coin—reducing barriers to matching investor preferences with available investment opportunities. Table 1 summarizes the strong relationship between capital formation and investor-choice protection.

3. Paternalistic Investor Protection

Investor-choice protection is not the only sense in which securities laws protect investors. Features of U.S. securities law described in this section reflect an alternative notion that I refer to as "paternalistic investor protection." Rather than maximizing investor choice, these securities regulations appear designed to

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61. *See infra* notes 79–85 and accompanying text (discussing why it is appropriate to analogize to other product markets).

62. *See* Schwartz, *supra* note 41, at 182 (describing a theory of investor protection whereby "disclosure protects investors by giving them the tools to look out for themselves").

63. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 297 (noting that "[a]s long as informed traders engage in a sufficient amount of searching for information and bargains, market prices will reflect all publicly available information"); Schwartz, *supra* note 41, at 181–85, 201–08 (discussing, but ultimately questioning, market prices as a form of investor protection).

save investors from their own bad decisions.[64] Paternalistic approaches, such as "merit review" of proposed stock terms, were prominent in state securities laws that preceded the '33 and '34 Acts.[65] Although the '33 and '34 Acts preempted most state-level regulation of securities transactions, paternalistic approaches do survive in subtle ways.[66]

For example, the regulatory framework for securities professionals, such as broker–dealers and investment advisers, imposes duties on these intermediaries when recommending investments. Securities professionals are potentially liable if they recommend transactions that are deemed "unsuitable" to a client.[67] Although the client's subjective investment goals are one element of suitability, the intermediary's recommendation must also be appropriate in light of the client's financial resources and age.[68] This objective notion of suitability imposes on some

64. *See* Guttentag, *supra* note 9, at 229–32 (explaining that "[t]here is less evidence in the historical record that federal securities regulations were enacted for the purpose of protecting investors from their own unwise investment decisions than might be expected"). Guttentag speculates that prominent advocates for the '33 Act and the '34 Act may have wanted to avoid blaming everyday investors for the harms suffered in the stock market crash. *Id.*

65. *See* Friedman, *supra* note 14, at 308 (giving an historical example of a Kansas banking commissioner who required banks to report withdraws by customers so that the commissioner could review potential investments with the withdrawn funds).

66. *See id.* ("In reality, [William O.] Douglas'[s] intuition that doses of paternalism were required for effective regulation has insinuated itself much more broadly than generally recognized into the federal scheme of securities regulation."). Friedman explains that "[t]hrough quasi-private self-regulatory organizations, the necessary paternalism emerged that Congress was unwilling to vest in the federal government directly." *Id.* Friedman gives the example of NASD Rules that require approval of underwriting terms in public offerings. *Id.*

67. *See* Cable, *supra* note 4, at 135–47 (describing the regulation of securities professionals).

68. *See* Fin. Indus. Regulatory Auth. Rule 2111 (2014) (providing that a broker–dealer is obligated to investigate and base recommendations on the client's "investment profile"). A client's investment profile includes the client's "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." *Id.* Investment advisers owe a similar duty to make suitable recommendations based on "the client's financial situation and investment objectives." SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 27–28 (2011).

investors a societal judgment about appropriate levels of financial risk.

Similarly, the SEC dedicates substantial resources to "investor education." Through these educational efforts, the SEC endorses conventional views of the personal finance industry regarding appropriate asset allocation, retirement planning, and diversification. For example, the SEC's website directs users to a personal finance calculator that produces a suggested allocation of investment assets based on the user's demographic information.[69]

Granted, an investor can easily escape these relatively mild paternalistic interventions.[70] An investor need not seek the advice of a broker–dealer before executing a transaction and can steer clear of the SEC's website. But these regulations and initiatives do represent an effort, way down in the plumbing of securities regulation, to shape and contain investor preferences rather than effecting preformed investor choice.

To be clear, paternalistic investor protection is not always in direct conflict with capital formation or investor-choice protection. Investors display well-documented cognitive shortcomings when making financial decisions.[71] Some securities regulations appear designed to quell immediate investor impulses and provide opportunity for more considered decision-making. For example, the '33 Act imposes a waiting period between a

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69. *See Beginners' Guide to Asset Allocation, Diversification, and Rebalancing*, SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/assetallocation.htm (last visited Nov 19, 2014) (directing the user, under the section titled, "How to Get Started" to a hyperlinked "online asset allocation calculator") (on file with the Washington and Lee Law Review). The SEC does state that risk tolerance must be decided by the individual investor. *Id.* Yet the asset allocation calculator is not greatly affected by varying the input for risk tolerance. *Id.*

70. One could call the SEC's approach "soft paternalism." *See* Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1162 (2003) ("Libertarian paternalism is a relatively weak and nonintrusive type of paternalism, because choices are not blocked or fenced off.").

71. *See* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 226–27 (2008) (summarizing various investor biases); Schwartz, *supra* note 41, at 204–07 (describing "biases that are thought to impact decision making in the investment context"); MALKIEL, *supra* note 46, at 235–52 (categorizing these biases into overconfidence, biased judgments, herding, loss aversion, and pride and regret).

public offer of securities and any actual sales.[72] Similarly, the '34 Act requires that tender offers remain open for a specified number of days so that target shareholders have time to carefully consider the offer.[73] These requirements may impede investor choice in the sense of checking immediate impulses, but they can be seen as ultimately enabling investor choice viewed at the time when cooler heads prevail.[74]

Paternalistic regulation may also facilitate capital formation by boosting "investor confidence." Though a frequently cited rationale for tightening securities regulations, investor confidence is, in fact, a nebulous concept with an unproven relationship to stock market participation.[75] In one form, investor confidence refers to a psychological, and sometimes irrational, sentiment that retail investors exhibit towards the market.[76] We may worry that unsophisticated investors will ascribe too much importance to negative experiences or events, and we may therefore try to

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72. *See* Guttentag*, supra* note 9, at 230.

73. 17 C.F.R. § 240.13e-4 (2014). A tender offer is an offer by an acquirer to buy the stock of a publicly traded company directly from shareholders. *See* PETER V. LETSOU, CASES AND MATERIALS ON CORPORATE MERGERS AND ACQUISITIONS 165–68 (2006). It is a common mechanism for a corporate takeover. *Id.*

74. Similarly, some legal scholars suggest that legal rules can play a "de-biasing" role by combatting cognitive biases and improving decision making. *See* Christine Jolls, *Behavioral Law and Economics*, *in* BEHAVIORAL ECONOMICS AND ITS APPLICATIONS 21 (Peter Diamond & Hannu Vartiainen eds., 2007) ("[L]egal policy may respond best to such errors [in decision making] . . . by operating directly on the errors and attempting to help people either to reduce or to eliminate them.").

75. *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 33 (2003) (noting that the SEC frequently relies on a rationale of restoring investor confidence without rigorously defining the concept or citing empirical evidence that investor confidence affects stock market participation).

76. *See* Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 415–20 (2002) (discussing the relationship between investor confidence and stock market participation, emphasizing the psychology of retail investors and factors affecting their long-term trust in markets). But, as Stout recognizes, reference to investor confidence does not require a paternalistic mindset—we may simply recognize that rational investors will shrewdly withdraw from a market plagued by insurmountable information asymmetry. *See id.* at 410–15 (discussing the rational-actor model); *supra* note 52 and accompanying text (considering how information asymmetry may cause some investors to withdraw from the market).

save investors from making mistakes so that they do not irrationally shun the market in the future.[77] In other words, saving investors from themselves may be important to maintaining robust public equities markets (capital formation).

At another level, however, paternalistic protection is in tension with capital formation and investor-choice protection. For example, an investor near retirement age may genuinely prefer to invest in a high-risk startup company. That choice does not necessarily indicate a defect in the investor's decision-making process, even if it defies the conventional views of the personal finance industry.[78] To the extent securities regulations impede that investment, a potential source of financing for the startup is eliminated, and the goals of capital formation and investor-choice protection are stifled.

One might think this concern is overstated to the extent securities are fungible cash flow rights and obligations. In theory, if securities laws restrict a particular investor from purchasing a particular security, (1) the company could turn to other investors or alternative financing sources and (2) the investor could obtain similar cash flow rights, with similar risk and return characteristics, from a different financial product. In some contexts, this may be true. Established companies do have a wide variety of financing sources available, including public equities, bond issuances, trade credit, and traditional bank financing.[79] Likewise, knowledgeable investors can construct a variety of cash flow combinations through investments in publicly traded stocks, index funds, mutual funds, private equity funds, life insurance products, real estate investments, and so on.[80] In some cases, any

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77. *See* Stout, *supra* note 76, at 430 ("Rather than dismiss the 'unsophisticated investor' as the weak animal that must sadly but necessarily be culled out of the investing herd in order to improve the species, perhaps we should pay close attention to his care and feeding.").

78. *Cf.* Jacob Hale Russell, *The Separation of Intelligence and Control: The Retirement Savings Crisis and the Limits of Soft Paternalism,* 6 WM. & MARY BUS. L. REV. (forthcoming 2015) (manuscript at 39–40) (considering, but ultimately rejecting, arguments for respecting unconventionally high-risk investment strategies in retirement plans).

79. *See* Stout, *supra* note 76, at 436 (suggesting that bear markets have limited impact on well-run companies because they can finance operations from sources other than equities markets).

80. *See infra* note 232 and accompanying text (discussing commonly owned assets).

particular paternalistic intervention may not move the needle in terms of capital formation and satisfying investor preferences.

But in other contexts, neither financing sources nor investment opportunities are so fungible. Businesses with limited operating history have difficulty accessing public equities markets,[81] bank financing,[82] and in many cases venture capital.[83] Likewise, some investors gain their competitive advantage through investing within a narrow area of technical expertise or within networks of personal or business relationships.[84] In addition, an investor may not be interested in cash flow rights alone. Investors may select investments based on special tax attributes or even for nonfinancial reasons, such as enthusiasm for a particular technology or community.[85]

In short, paternalistic protection does not have to be inconsistent with the goal of capital formation, but it often is. Table 1 summarizes this ambiguous relationship.

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81. *See infra* notes 92–95 and accompanying text (discussing the difficulties that small issuers face in complying with the mandatory disclosure scheme that accompanies public equities markets); *Going Public*, ENTREPRENEUR, http://www.entrepreneur.com/article/81394 (last visited Nov. 19, 2014) (suggesting that a company should have a valuation of $100 million to be an IPO candidate) (on file with the Washington and Lee Law Review).

82. *See* John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 869–70 (2005) ("Because of the way that rapid-growth start-ups are structured, they are generally not eligible for such commercial bank loans.").

83. *See Private Equity for Small Firms: The Importance of the Participating Securities Program: Hearing Before the H. Comm. on Small Bus.*, 109th Cong. 37–67 (2005) (statement of Colin C. Blaydon, Dir., Center for Private Equity and Entrepreneurship, and Susan L. Preston, Entrepreneur-in-Residence, Ewing Marion Kauffman Foundation) [hereinafter *Private Equity*] (discussing the "funding gap" that startups face after exhaustion of personal funds and the typical $5 million minimum investment amount of venture-capital funds).

84. *See* COOTER, *supra* note 45, at 27–38 (discussing the importance of relational finance to entrepreneurship); Cable, *supra* note 4, at 130 (discussing the investment practices of angel investors).

85. *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1437–39 (2008) (discussing nonfinancial motivations of angel investors).

4. Populist Investor Protection

A third notion of investor protection prioritizes participation of retail, as opposed to institutional, investors in securities markets.[86] A number of securities law requirements appear to have been designed to maintain a "level playing field" among investors of varying wealth, sophistication, and access to information. For example, Regulation FD under the '34 Act prohibits publicly traded companies from revealing information to professional securities analysts without simultaneous disclosure to the public.[87] Similarly, insider-trading rules are sometimes justified in terms of informational equality between company insiders and retail investors.[88] I call this policy goal "populist investor protection."

Like paternalistic investor protection, populist investor protection is not always in tension with the goal of capital formation. All other things being equal, broad participation in a market should improve its performance by increasing liquidity.

At other times, however, populist investor protection has a more distributive thrust that may be in tension with capital formation. Policymakers may value equal access to investment opportunities more than economic efficiency. For instance, some legal scholars argue that insider trading, if permitted, would in fact improve the accuracy and efficiency of stock markets and therefore assist high-quality issuers.[89] But policymakers may still prohibit insiders from trading on nonpublic information in the

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86. *See generally* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013) (critiquing the exclusion of retail investors from the private placement market); Langevoort, *supra* note 16; Stout, *supra* note 76, at 430 ("Rather than dismiss the 'unsophisticated investor' as the weak animal that must sadly but necessarily be culled out of the investing herd in order to improve the species, perhaps we should pay close attention to his care and feeding.").

87. 17 C.F.R. §§ 230.100–.103 (2014).

88. *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847–48 (2d Cir. 1968) (concluding that corporate insiders must either disclose material nonpublic information or abstain from trading).

89. *See* M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 503, 507–08 (2011) (summarizing the views of Henry Manne in INSIDER TRADING AND THE STOCK MARKET). *But see* WANG & STEINBERG, *supra* note 46, at 2.2.2 (citing sources disputing the assertion that insider trading rules improve accuracy of prices).

name of fairness to retail investors. Table 1 summarizes the ambiguous relationship between populist protection and capital formation.

III. Private Placement Exemptions: Why and How?

A. Why Private Placement Exemptions?

Based on the discussion above, one might wonder why there are any exemptions to a baseline rule of mandatory disclosure. Mandatory disclosure seems uniquely suited to meet all of the goals of securities law described above. By helping investors overcome information asymmetry, these regulations can be characterized as promoting capital formation and investor-choice protection by helping match investors and issuers.[90] Mandatory disclosure also squares with more paternalistic and populist notions of investor protection to the extent that even unsophisticated investors benefit from complex information as communicated through price.[91]

So, as a policy matter, why are some transactions exempt from these beneficial mandatory disclosure rules? When would the costs of mandatory disclosure outweigh its considerable benefits? To answer these questions, it is useful to think about the types of investment opportunities and investors typical of private placements.

In terms of investment attributes, consider startup companies with novel products or business plans.[92] In their initial stages, these companies typically seek "seed funding" in amounts ranging from $500,000 to $5 million.[93] The costs of complying with a mandatory disclosure regime, however, are somewhat

90. *See supra* Parts II.B.1–2 (discussing capital formation and investor-choice protection).

91. *See supra* Parts II.B.3–4 (discussing paternalistic and populist investor protection).

92. This is by no means the only or even predominant type of private placement. But the name of the JOBS Act, for example, demonstrates the central role that high-growth startups play in thinking about private placement regulation.

93. *See Private Equity*, *supra* note 83 (discussing the financing needs of startups prior to eligibility for venture capital).

fixed.[94] Engaging an accountant to perform an audit in connection with a $500,000 offering may cost more than one percent of the amount it cost to perform an audit in connection with a $50 million offering.[95] The costs of a comprehensive mandatory disclosure system could easily outweigh the entire value of a highly uncertain project in its relative infancy. Also, mandatory disclosure systems tend to emphasize historical facts over projections and future plans, and so provide little benefit to a company with limited or no operating history.[96]

Of course, private placement exemptions are not limited to startup companies, so it is useful to consider how investor attributes may also affect the costs and benefits of mandatory disclosure. Some categories of investors may not value mandatory disclosure because they benefit from a substitute means of overcoming information asymmetry. An investor may have a relationship to the issuer or its personnel that mitigates typical information imbalances and resulting agency costs—for example an employment relationship. Alternatively, an investor may have superior technical or financial knowledge or experience that results in above average ability to formulate disclosure requests, evaluate information, and negotiate favorable investment terms.

Venture-capital investors, for example, likely benefit from a number of these substitute protections. Silicon Valley is a close-knit market with many repeat players, so reputational considerations may limit opportunistic behavior by issuers.[97] Venture-capital investors tend to focus their investments in

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94. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 278 (discussing how mandatory disclosure laws may favor large issuers because they are not generally scaled).

95. *See* Chris Wand, *Do Venture Capitalists Demand Audited Financials?*, ASK THE VC, http://www.askthevc.com/wp/archives/2008/02/do-venture-capitalists-demand-audited-financials.html (last visited Nov. 19, 2014) (providing cost estimates for audited financials) (on file with the Washington and Lee Law Review); Easterbrook & Fischel, *supra* note 54, at 671 (stating that many of the costs of disclosure are the same regardless of the size of the firm or offering).

96. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 305 (explaining that mandatory disclosure obligations emphasize objective historical facts).

97. *See In re* Trados Inc. S'holders Litig., No. 1512-VCL, 2013 WL 4511262, at *28 (Del. Ch. Aug. 16, 2013) (noting the close-knit nature of the Silicon Valley environment).

particular industries where they have some technical expertise.[98] And venture-capital investors have developed standardized investment contracts particularly suited to the information asymmetry, agency costs, and uncertainty inherent in startup company investments.[99]

In sum, for certain types of transactions, the costs of mandatory disclosure may be disproportionate to the size of the contemplated transaction. And certain types of investors, who have substitute means of protection, may not value the benefits of mandatory disclosure. As a result, some transactions are exempted from the full-blown mandatory disclosure system and are instead subject to alternative regulatory mechanisms.

B. How Private Placements Are Regulated

At first glance, private placement regulation can appear too fragmented for precise analysis. The contours of private placement exemptions are defined through a patchwork of legislation, judicial interpretation, and rulemaking by the SEC. For example, § 4(a)(2) of the '33 Act provides a statutory exemption for sales "not involving any public offering."[100] Because this statutory exemption provides issuers with almost no guidance, courts stepped in to develop multi-factor tests delineating private (i.e., exempt) versus public offerings under the statute.[101] Addressing concerns that this case law was overly subjective and ad hoc, the SEC has developed safe harbor

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98. *See* Cable, *supra* note 44, at 238 ("In 2011, nearly 80 percent of V[enture] C[apital] investment was made in six industry sectors: software (24 percent), biotechnology (17 percent), industrial/energy (12 percent), medical devices and equipment (10 percent), media and entertainment (8 percent), and IT services (8 percent)." (citing statistics from the National Venture Capital Association)(footnote omitted)).

99. *See* Cable, *supra* note 4, at 120–26 (describing standard venture-capital investment contracts, drawing on the work of Ronald Gilson, George Triantis, and others); Jesse M Fried & Mina Ganor, *Agency Costs of Venture Capitalist Control in Startups,* 81 N.Y.U. L. REV. 967, 983, 989–90 (2006) (reviewing arguments for how preferred stock and board control reduce entrepreneur opportunism).

100. 15 U.S.C. § 77d(a)(2) (2012).

101. *See infra* note 106–110 and accompanying text (discussing case law under § 4(a)(2)).

exemptions associated with § 4(a)(2), such as Rule 506 of Regulation D.[102] Other SEC rulemaking is based on alternative statutory authority, such as § 3(b) of the '33 Act, which states that the SEC "may from time to time through its rules and regulations" create exemptions for securities issuances of $5 million or less.[103]

Stepping back from this patchwork of legal authorities, however, one can see in private placement regulations three primary mechanisms for protecting investors: scaled disclosure, sorting, and portfolio mechanisms. To date, scaled disclosure and sorting are the dominant mechanisms. Investor caps are a relatively rare example of a portfolio mechanism.

1. Scaled-Disclosure Mechanisms

Private placement exemptions may be conditioned on disclosure of specified information, though less than what is required for a registered offering. I call these requirements "scaled-disclosure mechanisms." For example, Regulation A allows for offerings of up to $5 million if the issuer provides financial statements prepared in accordance with generally accepted accounting principles and a disclosure document containing nonfinancial information similar to, but less comprehensive than, what would be contained in a prospectus for a registered public offering.[104] Similarly, the most popular private placement exemption, Rule 506, requires issuers to deliver this same information, but with audited financial statements, to any purchasers who do not meet certain wealth or income standards.[105]

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102. *See* 17 C.F.R. § 230.506 (2014) (enumerating an exemption for limited offers and sales without regard to the dollar amount of the offering).

103. 15 U.S.C. § 77c.

104. *See* 17 C.F.R. §§ 230.251–.263. For a good overview of the Regulation A exemption and the impediments to its more frequent use, see Rutheford B. Campbell, Jr., *Regulation A: Small Business' Search for a "Moderate Capital,"* 31 DEL. J. CORP. L. 77, 101–12 (2006).

105. *See* 17 C.F.R. § 230.506.

2. Sorting Mechanisms

Other exemptions require that issuers sell or offer securities to only those investors who meet specified criteria. I call these requirements "sorting mechanisms." In some cases, sorting mechanisms seek to identify investors with special relationships to the issuer that may serve as substitutes for registration and mandatory disclosure. For example, case law interpreting § 4(a)(2) often emphasizes the relationship between the issuer and investors. In *SEC v. Ralston Purina Co.*,[106] the seminal case under that exemption, the Court considered an issuer's sale of stock to its employees.[107] The Court held that a broad offering of stock to a wide range of employees did not qualify for the exemption, and the Court implied that a narrower offering to high-level executives, with meaningful access to information about the issuer, would qualify for the exemption.[108] Subsequent judicial opinions similarly state that an offering is more likely exempt when there is a "substantial preexisting relationship" between the issuer and the offerees.[109] The SEC has incorporated the concept of a substantial preexisting relationship into several of its safe-harbor exemptions.[110]

In other cases, investors are deemed qualified because of superior capability in assessing investments. The apparent financial sophistication of offerees has been an important factor in case law under § 4(a)(2).[111] Where courts perceive investors as

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106. 346 U.S. 119 (1935).

107. *See id.* at 120.

108. *See id.* at 125–26.

109. *See* Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 71–75, 104–09 (1989) (discussing the evolution of the "pre-existing relationship" requirement).

110. *See, e.g.*, 17 C.F.R. § 230.506 (2014) (prohibiting sales to nonaccredited investors by "general solicitation"). Through no-action letters, the SEC has suggested that the best way to avoid a general solicitation is to limit offers to persons with whom the issuer has a preexisting relationship. Cable, *supra* note 4, at 133–34. The SEC defines a preexisting relationship as one that is in place prior to the offering and that "would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration." *Id.* (quoting Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 WL 55694 (Dec. 4, 1985)).

111. *See id.* at 76 (discussing factors that courts consider in analyzing

having enough knowledge about financial matters to request and assess relevant information from the issuer, an offering is more likely to be considered private and therefore exempt.[112]

In an effort to provide issuers with more certainty than the § 4(a)(2) case law, the SEC has incorporated proxies for investor sophistication into its safe-harbor exemptions. The "accredited investor" standard is the most prominent proxy for investor sophistication.[113] To qualify as an accredited investor, an individual must have annual income of at least $200,000 per year ($300,000 if filing jointly with a spouse) or net assets of at least $1 million (excluding equity in a primary residence).[114] Although the SEC's safe-harbor exemptions are not, in theory, limited to accredited investors, an issuer receives a number of important benefits by limiting an offering to accredited investors. Under the popular Rule 506 exemption, an issuer is not required to provide audited financial statements or other specified disclosure to accredited investors and may engage in a general solicitation if all purchasers are accredited.[115]

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§ 4(a)(2)).

112. *See id.* at 75–84 (examining case law that focuses on investor sophistication).

113. *See* Campbell, *supra* note 14, at 929 (discussing the high rate at which issuers rely on exemptions requiring accredited-investor status); Friedman, *supra* note 14, at 299–300 (discussing the origins of the accredited–investor standard).

114. *See* 17 C.F.R. § 230.501 (providing definitions for Regulation D).

115. *See id.* § 230.502 (setting forth disclosure requirements for Regulation D); *supra* note 4 (discussing recent reforms that permit general solicitation if all investors are accredited). Relief from providing audited financial statements is a particularly important advantage because a startup company is unlikely to have audited financials and investors are unlikely to value them. *See* THERESE H. MAYNARD & DANA M. WARREN, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING 234 (2010) (discussing the burdens of required disclosure to non-accredited investors). Accordingly, Rule 506 offerings including nonaccredited investors are relatively rare. *See* Jennifer Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993, 1002 n.56 (2012) (discussing a recent study of Regulation D offerings indicating that 90% included only accredited investors).

3. Portfolio Mechanisms (Including Investment Caps)

Even before the JOBS Act introduced investment caps, some aspects of federal private placement regulation subtly reflected an alternative method of protecting investors. Instead of emphasizing receipt of particular information or perceived capabilities, these mechanisms focus on the overall financial condition of the purchaser. I call these "portfolio mechanisms."

For example, one commentator suggests regulators did not initially view wealth standards, such as accredited investor status, as proxies for investment capability.[116] Instead, wealth standards initially ensured that purchasers had adequate liquidity to hold presumably illiquid securities for a long period.[117] The concept was not that wealthy investors had the ability to reduce risk through self-help but rather that they could absorb risk due to their general financial situation.[118]

The ban on general solicitation, which prohibits public solicitation of investors under several exemptions,[119] has also acted in part as a portfolio mechanism because it channels sales efforts through broker–dealers.[120] Under SEC no-action letters interpreting the ban, broker–dealers are granted significantly more leeway than issuers in locating investors.[121] Therefore, an issuer who wants to cast a relatively wide net in searching for investors may be motivated to sell through a broker–dealer.[122] As discussed above, broker–dealers must determine that investments are suitable based on the purchaser's overall financial condition.[123]

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116. *See* Friedman, *supra* note 14, at 299–310 (discussing the role of wealth standards in Rule 146, which was a precursor to Rule 506).

117. *See id.*

118. *See id*.

119. *See supra* notes 4, 110 and accompanying text (discussing the ban on general solicitation).

120. *See* Cable, *supra* note 4, at 135 (explaining how SEC regulations encourage use of intermediaries).

121. *See id.* (discussing SEC no-action letters).

122. *See id.* Of course, the ban on general solicitation may not affect issuer practices to the same extent now that it has been lifted for sales to accredited investors.

123. *See supra* notes 67–68 and accompanying text (providing an overview of a broker–dealer's obligation to determine that recommendations are suitable

The investment cap contained in the JOBS Act's new crowdfunding exemption is a more explicit example of a portfolio mechanism. Under the new exemption, the amount each individual can invest in crowdfunding transactions is capped according to the investor's net worth and annual income.[124] For example, an investor with a net worth of $75,000 (and annual income at or below that level) can invest a maximum of $3,750 in crowdfunding offerings annually. An investor with a net worth of $750,000 (and annual income at or below that amount) can invest a maximum of $75,000 in crowdfunding offerings annually.[125] No investor may purchase more than $100,000 in crowdfunding offerings annually regardless of wealth.[126] Investment caps are relatively common at the state level but new to federal law.[127]

Though an investment cap may not reduce the risk that any individual investment will fail, it may reduce an investor's overall exposure to financial risk by forcing modest diversification. For example, assume lawmakers enact a registration exemption with a simple investment cap that prevents any single purchaser from

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based on a potential investor's investment profile).

124. *See* 15 U.S.C. § 77d(a)(6)(B) (2012) (requiring issuers to adhere to an investment cap taking into account only sales from that issuer); *id.* § 77d-1(a)(8) (requiring crowdfunding intermediaries to ensure that a purchaser stays within an aggregate annual limit across all crowdfunding transactions); *supra* note 10 (discussing the aggregate annual limit).

125. *See id.* § 77d(a)(6)(B). The language enacted by Congress is ambiguous regarding how the cap is calculated. Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66428, 66433 (Nov. 5, 2013). The SEC takes the position that if either annual income or net worth is at or above $100,000, then the investor may purchase an amount equal to 10% of the measure that exceeded $100,000. *Id.* at 66433–34. But if both annual income and net worth are below $100,000, the SEC takes the position that the investor is limited to 5% of annual income or net worth (whichever is higher). *Id.*

126. *See* 15 U.S.C. § 77d(c) (providing investment limits at lower income and net asset levels).

127. The investment cap in the JOBS Act resembles a provision of the Uniform Limited Offering Exemption adopted by several states. *See, e.g.*, WASH. ADMIN. CODE § 460-44A-505 (2014) (imposing an investment cap on certain limited offering exemptions). This exemption allows sales to nonaccredited investors as long as the investment is suitable to the investor. *Id.* § 460-44A-505(2)(c)(i). An investment is deemed suitable if the investment amount does not exceed 10% of the investor's net worth. *Id.* The SEC recently proposed an investment cap in connection with recent revisions to Regulation A. *Supra* note 38.

investing more than 10% of his or her net worth in a single company. If an angel investor with a $1 million net worth would otherwise invest $200,000 in a single startup, he or she might be forced by the investment cap to divide the investment amount over multiple startups or look to other types of investments (such as publicly traded stock or mutual funds). It is a basic tenant of corporate finance theory that diversification can reduce aggregate financial risk to an investor while maintaining returns.[128] Just how effective diversification is at reducing risk depends on the nature of all assets held by the investor and their tendency to rise and fall in value at the same time (covariance), a topic reserved for Part IV.C below.[129]

In addition to these diversification benefits, investment caps can mitigate risks associated with illiquidity. Securities issued in private placements are difficult to re-sell due, in part, to regulatory factors. When an issuer sells a security pursuant to an exemption from registration, only that initial sale is exempt.[130] Secondary transactions—resale by the investor to a third party—are not automatically exempt and so investments sold in private placements are not eligible for most secondary markets, such as traditional stock exchanges where buyers and sellers are easily matched.[131] As a result, an investor in a private placement must be prepared to hold the security for an extended period, potentially affecting his or her ability to meet current obligations. Investment caps can help ensure that a single, illiquid investment does not dominate an investor's portfolio.

In sum, investment caps and other portfolio mechanisms rest on a different logic than scaled disclosure or sorting. As stated in the introduction, scaled disclosure and sorting are smart-money approaches because they try to reduce the risk of a failed investment by mitigating information asymmetry (making

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128. *See infra* notes 194–202 and accompanying text (discussing investment caps within the context of diversification and investment volatility).

129. *See infra* notes 190–97 and accompanying text (discussing the extent to which diversification reduces volatility).

130. *See, e.g.*, 17 C.F.R. § 230.502 (2014) (stating that securities sold in Regulation D offerings are restricted securities).

131. *See id.* § 230.144 (describing limited circumstances in which a purchaser of securities can re-sell restricted securities without being deemed an underwriter).

investors smarter) and limiting the market to capable (smart) investors.[132] In contrast, investor caps and other portfolio mechanisms assume that there is a substantial risk of failed investment and try to limit the consequences for the purchaser's overall financial condition.[133] I refer to this as a mad-money approach because it anticipates and allows risky investments but only within parameters.[134]

IV. Evaluating the Mechanisms: In Theory and Practice

The smart-money approaches of scaled disclosure and sorting currently dominate private placement regulation. This Part seeks to understand why by first articulating a theoretical case for this current approach. But this Part goes on to identify practical considerations that seriously undermine the effectiveness of scaled disclosure and sorting. Taking these practical considerations into effect, the mad-money approach of investment caps becomes more appealing.

A. The Theoretical Appeal of Disclosure and Sorting (Smart Money)

To understand the current state of private placement regulation, it is helpful to first give smart-money approaches the

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132. *See supra* notes 3–5 and accompanying text (explaining this Article's terminology of smart money).

133. *See supra* notes 126–29 and accompanying text (discussing the diversification and liquidity goals of investment caps).

134. *See supra* note 12 and accompanying text. The distinction between smart-money approaches and investment caps bears some resemblance to Stephen Choi's distinction between regulating investments and regulating investors. Mercer Bullard, On Regulating Investors: The JOBS Act and the Accredited Investor Standard 4–6 (July 13, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2468031 (discussing the logic of investment caps) (on file with the Washington and Lee Law Review). Choi has argued that regulators should regulate investors rather than issuers, with unsophisticated investors being limited to passive index funds. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Approach,* 88 CALIF. L. REV. 279, 300–01 (2000). While this focus on investor portfolio construction bears some resemblance to this Article's analysis, Choi's proposals rely heavily on sorting mechanisms that this Article disfavors. *Id.*

benefit of the doubt by assuming they are effective in achieving their objectives. This Part therefore assumes that scaled disclosure provides information that investors actually value and that sorting mechanisms effectively distinguish capable from incapable investors. This Part then compares these mechanisms to an investment cap that is effective in achieving its objectives of encouraging diversification and liquidity. This comparison reveals that smart-money approaches may have comparative advantages over investment caps *in this hypothetical setting.*

1. Smart Money in a Perfect World

At first blush, scaled disclosure seems a sensible response to the special attributes of private placements described above. If there are fixed costs to mandatory disclosure that renders it impractical for smaller transactions,[135] perhaps the amount of disclosure can simply be adjusted. Through properly calibrated disclosure requirements, regulators could try to specify helpful, standardized disclosure requirements that individual market participants benefit from but lack adequate incentives to create and maintain.[136] Such a regulatory scheme would advance capital formation and investor-choice protection in much the same way as the full-blown mandatory disclosure scheme for registered offerings.[137]

But even if disclosure requirements can be scaled down in this manner—something this Article questions below—disclosure is unlikely to be the whole answer in the context of private placements. Unlike securities sold in registered offerings, securities sold in private placements are illiquid and cannot be re-sold through an exchange such as Nasdaq or NYSE.[138] In the rare instances in which secondary markets for private placement

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135. *See supra* notes 94–96 and accompanying text (discussing the fixed costs of mandatory disclosure).

136. *See supra* note 56 and accompanying text (identifying third-party effects of mandatory disclosure).

137. *See supra* notes 60–63 and accompanying text (discussing the relationship between capital formation and investor-choice protection).

138. *See supra* notes 130–31 and accompanying text (discussing limitations on resales of restricted securities).

securities have emerged, the effectiveness of those markets in accurately pricing securities is questionable.[139]

This illiquidity has significant implications for private placement regulation. One of the primary justifications for the mandatory disclosure system is that experts will quickly digest information and communicate it to the public markets through price.[140] But without a public market, each investor must independently assess a company's disclosures.[141] Given the evidence that individual investors either exhibit flawed decision-making or simply lack resources to process voluminous information,[142] scaled disclosure alone is problematic.

One problem, of course, is that vulnerable investors may be misled or may misconstrue information and make investments that they misunderstand. In that case, it is debatable whether those investors are satisfying their preferences in any meaningful way.[143]

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139. For instance, Facebook stock traded on secondary markets (SharesPost and SecondMarket) prior to the company's IPO. ROBERT BARTLETT, BERKELEY LAW, POST-JOBS ACT CHALLENGES AND SOLUTIONS IN "PRIVATE" SECONDARY TRADING MARKETS 17 (2012), http://www.sec.gov/info/smallbus/sbforum111512-materials-bartlett.pdf. Robert Bartlett determined that prices quoted on those secondary markets substantially exceeded issuers' own valuations used for pricing stock option grants. *Id.* For a comprehensive analysis of newly emerging secondary markets and associated regulatory issues, see generally Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179 (2012) (discussing the potential benefits of, and regulatory challenges associated with, new secondary markets).

140. *See supra* note 63 and accompanying text (discussing how market prices impound information).

141. *See* Friedman, *supra* note 14, at 297 (stating that "[i]nvestors cannot rely on pricing in . . . undeveloped markets to accurately reflect known information about the risk and return characteristics of the securities involved").

142. *See* Schwartz, *supra* note 41, at 204–07 (discussing cognitive biases displayed by investors).

143. *See* Langevoort, *supra* note 16, at 1042–43 (examining the policy implications of investors' bounded rationality and stating that the SEC rejects "classical economic argument" regarding efficiency of exchange transactions with respect to "naïve, unsophisticated" investors); *c.f.* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability,* 70 U. CHI. L. REV. 1203, 1206, 1243–44 (2003) (arguing that traditional economic rationales for enforcing terms of form contracts lose force when buyers are only boundedly rational and therefore agree to terms that fail to satisfy even their own preferences).

The presence of incapable investors may even negatively affect *capable* investors by creating incentives for fraud and misinformation, counter to the goals of capital formation and investor-choice protection. When there are a large number of incapable investors in the market, companies may turn their efforts to hard sales tactics designed to influence unsophisticated investors, rather than providing the more meaningful information demanded by sophisticated investors. As Frank Easterbrook and Daniel Fischel explain:

> [I]t is possible that . . . promoters may find the gains from deception greater than the reputational loss. This is especially likely if the public contains a pool of persons who cannot evaluate information and therefore cannot tell good projects from bad. Call them suckers. If there are enough suckers, sellers may make a living dealing exclusively with them, abandoning all prospects of sales to the informed. It follows that some firms will find fraud to be the project with the highest net present value.[144]

At some level of pervasive misinformation, we might expect capable investors to simply drop out of the market, as distinguishing good from bad investments becomes too costly.[145] A sorting mechanism potentially counteracts this harmful dynamic by limiting the market to capable investors least susceptible to fraud and removing the "suckers."[146]

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144. *See* EASTERBROOK & FISCHEL, *supra* note 46, at 281.

145. *See* Easterbrook & Fischel, *supra* note 54, at 674 ("A world with fraud, or without adequate truthful information, is a world with too little investment, and in the wrong things to boot.").

146. It may seem implausible that sorting mechanisms could have much effect on fraud because a determined fraudster may simply disregard private placement regulations and sell to whomever he or she considers a good mark. *Cf.* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CINCINNATI L. REV. 1023, 1034 (2000) (discussing why mandatory disclosure may be ineffective against fraud). But evidence suggests fraud is not a binary choice, and that "honest cheaters" may engage in what they perceive as minor transgressions while largely complying with other legal requirements to maintain their self-image as honest people. Michael D. Guttentag, *Stumbling into Crime: Stochastic Process Models of Corporate Fraud*, *in* HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 205, 211 (Alon Harel & Keith N. Hylton eds., 2012) 5–7 (discussing work of Dan Ariely and others). Also, even a determined and blatant fraudster might comply with private placement exemptions while committing fraud if he or she believes that a registration exemption would be relatively easy to prove while a fraud claim would be more difficult for victims to

Sorting mechanisms and scaled disclosure are therefore a theoretically appealing combination for regulating private placements. Scaled disclosure is strongly consistent with the goal of capital formation to the extent that it corrects a failure in the market for disclosure and therefore draws additional investors into the market.[147] While sorting does eliminate some sources of financing, there are offsetting benefits to capital formation if eliminating incapable investors improves the overall quality of information in the market by reducing incentives for fraud.[148]

A combination of scaled disclosure and sorting might also be strongly consistent with at least two varieties of investor protection. Scaled disclosure is strongly consistent with investor-choice protection if it helps investors satisfy their preferences by providing capable investors with better information than they reasonably could obtain through their own efforts.[149] While sorting may at first appear inconsistent with investor-choice protection by excluding some people from the market, a truly effective sorting mechanism would exclude only those incapable of making informed investment choices and it is unclear how much weight ought to be given to facilitating *uninformed* investing, particularly if it has a deleterious effect on the overall quality of information and drives some capable investors out of the market.[150] Sorting mechanisms are in obvious tension with populist investor protection (by excluding many investors entirely from private placements).

Table 2 recaps these theoretical strengths of scaled disclosure and sorting. In sum, a combination of scaled disclosure and sorting is strongly consistent with capital formation and two of

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prove because of subjective elements such as scienter and materiality.

147. *See supra* notes 135–37 and accompanying text (explaining how scaled disclosure might advance capital formation).

148. *See supra* notes 145–46 and accompanying text (discussing how effective sorting potentially reduces incentives to defraud).

149. *See supra* notes 135–37 and accompanying text (discussing how scaled disclosure could advance investor-choice protection).

150. *See supra* notes 135–37 and accompanying text (describing how a market with high levels of fraud could push out sophisticated investors); *supra* note 143 (suggesting that traditional economic justifications may be less compelling when investors appear to be making mistakes that do not reflect their true preferences).

three forms of investor protection—investor-choice and paternalistic.

2. Investment Caps in a Perfect World

Even if investment caps function well (encouraging diversification and liquidity), they have an ambiguous relationship with the goals of securities regulation. In terms of investor protection, caps are comparable to effective scaled disclosure and sorting, albeit with slightly different strengths and weaknesses. In contrast to scaled disclosure and sorting, investment caps are moderately aligned with the goal of populist investor protection by allowing everyone at least some access to private placements. Like scaled disclosure and sorting, an effective cap strongly advances paternalistic investor protection—though by mitigating the consequences of failed investments, rather than preventing failed investments.[151] Where investment caps seem inferior to well-functioning sorting and scaled disclosure is investor-choice protection. A cap may prevent even capable investors from fully satisfying their preferences. In other words, "grandma" may in fact be a savvy financial thrill seeker, and her large investment in a startup might have been wealth maximizing.[152]

For related reasons, investment caps are in some tension with capital formation, at least relative to well-functioning sorting and scaled disclosure. Limiting the autonomy of risk-preferring investors may drive up issuers' transaction costs by increasing the number of investors required for a given financing; in some cases, it may prevent a financing from happening altogether.

There is a silver lining for investment caps and the related goals of capital formation and investor-choice protection. Like sorting, portfolio mechanisms might helpfully change the

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151. *See supra* note 134 and accompanying text (contrasting smart-money approaches and investment caps).

152. There is a tradition of referring to vulnerable or impressionable investors as grandma. *See, e.g.*, Johnson, *supra* note 115, at 994 ("Grandma, and her money, are in need of protection"). In truth, this author's grandmothers were especially financially savvy.

equation for fraud. In deciding whether to engage in fraud, a calculating fraudster presumably balances the cost of identifying and luring victims against the potential payoffs.[153] By requiring a fraudster to lure more victims for the same aggregate payoff, compelled diversification may drive some fraudsters to instead pursue legitimate business projects or scams not involving securities, thereby advancing capital formation and investor-choice protection by improving the overall quality of information in the market.[154] For this reason, one could describe portfolio mechanisms as moderately aligned with capital formation and investor-choice protection.

Table 2 recaps these theoretical strengths and weaknesses of investment caps and compares caps to smart-money approaches. In sum, investment caps compare reasonably well on investor-protection grounds (albeit with different strengths and weaknesses than smart-money approaches), but have a more ambiguous relationship to capital formation.

B. The Practical Problem of Universality

Despite their superior theoretical appeal, scaled-disclosure and sorting prove difficult to implement effectively. This Part describes those difficulties and focuses on one potential cause—the broad range of investment products governed by private placement regulations.

1. Universality and the Failure of Scaled Disclosure

Issuers rarely use exemptions that require scaled disclosure. Regulation A's disclosure requirements, while less demanding than a registered public offering, are considered too onerous.[155]

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153. *See* Cormac Herley, *Why Do Nigerian Scammers Say They Are From Nigeria?*, MICROSOFT RESEARCH, http://research.microsoft.com/apps/pubs/default.aspx?id=167719 (last visited Nov. 19, 2014) (discussing the "per-target" effort of financial scammers) (on file with the Washington and Lee Law Review).

154. *See supra* notes 145–46 and accompanying text (describing how sorting may reduce fraud and improve information).

155. *See* Campbell, *supra* note 104, at 82–83 (proposing reforms to Regulation A).

Similarly, issuers customarily limit Rule 506 offerings to accredited investors in order to avoid the disclosure requirements triggered by sales to non-accredited investors.[156]

The infrequent use of scaled-disclosure mechanisms suggests the approach has failed in its goal of overcoming market failures. Investors do not seem to value information that the SEC requires for these exemptions. Put another way, the required disclosure is not what investors would bargain for in the absence of market failure.

The failure of scaled disclosure pushes activity to exemptions that rely heavily on sorting mechanisms,[157] but commentators express doubt that those exemptions effectively protect investors. In particular, increasing reliance on the accredited-investor standard is puzzling. In addition to the criticism that the income and net worth standards are in need of adjustment—they are largely unchanged since the early 1980s—there is a more fundamental question as to whether those standards are meaningful proxies for investment capability.[158]

If scaled-disclosure and sorting mechanisms are flawed in practice, there are a number of possible explanations. Scholars variously charge that Congress and regulators are susceptible to interest-group pressure, lack proper incentives, suffer from cognitive limitations, or too easily fall prey to the wrong ideology.[159] This Article focuses on a different regulatory

156. *See* Johnson, *supra* note 115, at 1002 n.56 (citing a study indicating that over 90% of Regulation D offerings are limited to accredited investors).

157. *See id.* (discussing the popularity of Regulation D offerings that are limited to accredited investors).

158. *See* Friedman, *supra* note 14, at 291, 299 (suggesting that the accredited-investor standard leaves wealthy but unsophisticated investors vulnerable); Jennifer Johnson, *Private Placements: A Regulatory Blackhole*, 35 DEL. J. CORP. L. 151, 191–92 nn.242–43 (2010) (arguing that "there is also a growing recognition that the accredited-investor standard provides insufficient protection for investors"); Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 22 (1998) (questioning the relationship between wealth standards and financial sophistication); Greg Oguss, Note, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285, 288–90, 301–09 (2012) (cataloguing criticisms of the accredited-investor definition and providing recent case studies of fraud allegations by institutional investors).

159. *See* Easterbrook & Fischel, *supra* note 54, at 671 (discussing interest-group pressure and securities law); M. Todd Henderson & Frederick Tung, *Pay*

challenge: the broad range of investment products Congress and the SEC are trying to regulate.

For the most part, exemptions are not tied to specific kinds of issuers. Investment in an oil and gas partnership is subject to the same rules as investment in a high-tech startup, a private offering of public-company stock (a PIPE transaction), or a worm farm.[160] In describing the wide range of financial arrangements subject to regulation as securities, a leading treatise states: "The catalogue of these schemes is as variegated as the imaginations of promoters."[161]

This attempt to address a wide variety of investment types through one set of rules—what I call "universality"—complicates development of scaled-disclosure requirements. Simply put, different types of information are relevant to different investment products.

Consider two investments typically offered to individuals through private placement offerings: oil and gas partnerships and angel investments in high-tech startup companies.[162] Oil and gas partnerships are formed by promoters who identify, develop, and manage drilling projects.[163] The promoters fund their projects by soliciting investment from wealthy individuals who will be passive investors.[164] Angel investors are individuals who invest in

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for Regulator Performance, 85 S. CAL. L. REV. 1003, 1031–40 (2012) (discussing incentives of regulators); Choi, *supra* note 75, at 317–19 (discussing cognitive biases of regulators); Friedman, *supra* note 14, at 291–93 (discussing the influence of ideology on regulators).

160. *See* Smith v. Gross, 604 F.2d 639, 643 (9th Cir. 1979) (holding that an interest in a worm farm constituted a security); Oguss, *supra* note 158, at 310–11 (noting the "tremendous range of contemporary investment products" and the associated difficulty of devising any single "financial literacy exam"); *supra* note 29 and accompanying text (discussing the definition of a security under federal law).

161. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 246–64 (5th ed. 2004).

162. The angel investment market is estimated at $25 billion annually. Ibrahim, *supra* note 85, at 1419 n.57. The market for private placement oil and gas partnerships is approximately $700 million annually. *See* KATHY HESHELOW, INVESTING IN OIL & GAS: THE ABCS OF DPPS (2d ed. 2010) (providing an estimate for "private placement drilling programs" in 2005).

163. *See* HESHELOW, *supra* note 162, at 98–108 (explaining how oil and gas partnerships are established).

164. *Id.* at 8–11. *See* JOHN ORBAN, III, MONEY IN THE GROUND: INSIDER'S GUIDE TO OIL & GAS DEALS 177–96 (4th ed. 2006) (explaining how funding is

high-growth startups, typically after a company's founders have exhausted personal resources but before these companies are established enough to obtain venture capital.[165]

At some level of generalization, the same types of information may be relevant to both investments. In both cases, investors will presumably seek information about the promoters' (or founders') prior track record and expertise, the anticipated costs of the project, and projected returns.[166] But at the level of specificity that informs actual investment decisions, relevant information will be quite different. For example, the projected cost of an oil and gas drilling project is driven largely by geological and technical factors, such as anticipated well depth and drilling conditions, which are inapposite to an investment in a technology startup. [167] Conversely, projected returns for a high growth startup are driven by the size of the potential market for a new product and the ability to capture a large share of that market through intellectual property rights and besting potential competitors, none of which is obviously relevant to a drilling operation.[168]

Note that the type of historical information required by most scaled-disclosure mechanisms, such as financial statements, is not particularly important to evaluating either investment opportunity.[169] That is not to say, however, that historical financial information is never important to investors. A key employee who is offered the opportunity to invest in his or her privately owned employer, for example, would likely value information about past and current profitability and the extent of

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obtained for oil and gas projects).

165. *See* Cable, *supra* note 4, at 108–17 (providing an overview of angel investing); Ibrahim, *supra* note 85, at 1416–25 (describing angel investing).

166. *See* HESHELOW, *supra* note 162, at 98–108 (identifying information relevant to selecting an oil and gas partnership investment); MAYNARD & WARREN, *supra* note 115, at 9–10, 235, 461 (describing topics expected to be covered in a startup company business plan seeking outside investment).

167. *See* HESHELOW, *supra* note 162, at 100–02 (listing factors that are considered in projecting the costs of a drilling project).

168. *See* MAYNARD & WARREN, *supra* note 115, at 9–10, 235, 461 (explaining factors that are considered in projecting the return on investment in a startup company).

169. *See supra* note 104 and accompanying text (discussing informational requirements of Regulation A and Rule 506 of Regulation D).

past distributions to equity holders. The point is that crafting universally relevant disclosure standards at the level of specificity necessary to substantially aid investors is daunting.

One might object that this argument proves too much—the baseline rule of mandatory disclosure for public offerings also applies across a wide range of investment products. Public equities markets include issuers in distinct industries offering securities with distinct features, and the system seems to function well enough. Why doesn't the problem of universality similarly plague public offerings? In fact, some mandatory disclosure requirements imposed by the SEC are industry specific.[170] More generally, the accounting profession often develops standards tailored to particular industries, which shape the audited financial statements required in connection with public offerings.[171] In other words, the SEC mostly delegates the task of developing industry-specific disclosure to the accounting profession. This same approach has not proven effective in the private placement context, presumably because historical financial information is often less important to the types of businesses that rely on private placements and because obtaining audited financials represents a fixed cost that may be disproportionate to smaller private placements.[172]

2. Universality and the Failure of Sorting

Universality is not just a problem for scaled disclosure. It also poses a challenge for sorting mechanisms.[173] Policymakers

170. *See, e.g.*, 17 C.F.R. § 229.1100 (2014) (imposing special disclosure requirements with respect to securitization assets in Regulation AB); *id.* § 210.9. (imposing special disclosure requirements on bank holding companies in Article 9 of Regulation S-X); 15 U.S.C. §§ 80a-1–80a-64 (2012) (subjecting mutual funds to a separate statutory scheme through the Investment Company Act of 1940); Guttentag, *supra* note 50, at 178–79 (discussing industry-specific disclosure requirements imposed on publicly traded companies in the oil and gas sector).

171. *See generally* ERNST & YOUNG, ACCOUNTING STANDARDS CODIFICATION 985–605, SOFTWARE–REVENUE RECOGNITION (2014) (describing accounting principles for recognizing revenue from software licensing agreements).

172. *See supra* notes 94–96 and accompanying text (explaining that the cost of disclosures may not be proportionate to the size of a firm or offering).

173. *See* Oguss, *supra* note 158, at 310–11 ("[F]inancial literacy can mean very different things in different contexts . . . . Accordingly, it is hard to imagine

sometimes equate investor sophistication with general financial literacy.[174] But this focus misses an important component of investor capability—familiarity with conventions that vary significantly across different investment products.

In a previous article, for example, I described the conventional set of contract terms and practices angel investors use to mitigate the extreme information asymmetry, uncertainty, and agency costs associated with startups.[175] Among those conventional contractual terms are receipt of corporate preferred stock[176] and—less frequently—representation on a corporate board of directors.[177]

Investors in oil and gas projects also face significant information asymmetry, uncertainly, and agency costs, yet conventional investment terms in this context are quite different from an angel investment. For one, drilling projects are typically organized as "pass-through" entities—limited liability companies or limited partnerships—rather than the corporate form used for angel investments in startups.[178] In addition, oil and gas investors and promoters receive distributions of cash as soon as the project begins generating profits, while angel investors and

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any one exam of a reasonable length that could accurately measure an investor's or a purchaser representative's relevant knowledge in all such contexts.").

174. *See* Willis, *supra* note 71, at 199–203 (discussing increased efforts to promote financial literacy).

175. *See* Cable, *supra* note 4, at 124–31 (describing how venture capital and angel investors use preferred stock, board representation, negative covenants, and other mechanisms to mitigate information asymmetry).

176. Preferred stock gives investors (a) financial preferences over the founders in the case of a company failure and (b) conversion into common stock in the event of an IPO or trade sale. The financial preference might serve a useful signaling function because only a founder who is confident in their abilities would agree to it. *See id.* at 124–25 ("By agreeing to the liquidation preference for the V[enture] C[apital] fund, but accepting common stock for themselves, entrepreneurs may be signaling their confidence . . . ."). The conversion of preferred stock into common at an IPO may reflect a bargain to return control to the founders once the period of greatest uncertainly has passed. *See id.* at 124–27 (discussing the work of Ronald Gilson, George Triantis, and others).

177. Board representation allows angel investors to monitor the progress of the founders in achieving their business plans. *See id.* at 125.

178. This significantly affects the accounting and tax treatment of the project's operations. HESHELOW, *supra* note 162, at 8–9; ORBAN, *supra* note 164, at 161–75.

startup company founders typically receive a return on their investment only when the company is sold or achieves an initial public offering.[179]

A number of contextual differences account for these contrasting investment conventions. The choice of entity is likely explained by tax law, which is especially favorable to oil and gas exploration.[180] The timing of cash distributions reflects fundamental differences in the nature of the underlying business ventures. An oil and gas drilling project is a depleting asset that generates cash flows relatively quickly with limited additional capital after an initial investment in equipment and evaluation of the prospect.[181] A high-growth startup, in contrast, ordinarily requires ongoing capital investment (including reinvestment of any early profits) to develop the kinds of products, and achieve the scale, necessary for an initial public offering or profitable acquisition.[182]

For the purposes of this Article, the critical point is only that investing conventions vary significantly across investment products. We cannot assume that a savvy angel investor is also a savvy investor in oil and gas partnerships. Investment experience, and therefore sophistication, is context specific.

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179. *See* HESHELOW, *supra* note 162, at 97–101 (suggesting that oil and gas partnerships begin distributing cash as early as six months after investment and can completely "pay out" in two to three years).

180. Pass-through entities are generally superior to corporations for tax purposes because they avoid double taxation. Angel investors, however, may agree to a corporate form because subsequent venture-capital investors prefer them (for their own somewhat esoteric tax reasons) and because the benefits of pass-through treatment may be diminished by the alternative minimum tax. *See* MAYNARD & WARREN, *supra* note 115, at 112–28 (detailing the tax advantages of various business entities). Oil and gas partnerships receive beneficial tax treatment that avoids the alternative minimum tax problem. HESHELOW, *supra* note 162, at 89–93.

181. *See* HESHELOW, *supra* note 162, at 118 (explaining the financing and revenue structure of a drilling project).

182. *See* Cable, *supra* note 44, at 229 (explaining the importance of scalability to venture-capital investors).

3. The Result: Counterproductive Smart-Money Approaches

The historical failures of scaled disclosure and sorting have important implications. Specifically, the comparison of theoretical strengths described in Part IV.A and Table 2 is not the most helpful exercise for guiding policy. Instead, it is necessary to evaluate smart-money approaches in their inevitably flawed states. Viewed this way, scaled disclosure and sorting are not only less effective than they originally appear; they are potentially counter-productive.

Capital formation is hindered by scaled disclosure that compels information investors do not value. Such compelled disclosure becomes an additional transaction cost rather than a solution to a market failure.[183] At the margins, this additional transaction cost may drive some potential investors in a private offering to other investment opportunities.

Capital formation may also suffer from ineffective sorting mechanisms. Recall that effective sorting mechanisms—those that accurately distinguish between capable and incapable investors—might help quality issuers by eliminating noise from the market and reducing incentives for misinformation.[184] In contrast, sorting mechanisms based on wealth standards alone may do the opposite by identifying and leaving unprotected ideal candidates for fraud—wealthy but unsophisticated investors.[185] The dynamic is similar to that observed in a paper popularized by Steven Levitt and Stephen Dubner in their recent book *Think Like a Freak*.[186] Dubner and Levitt describe the work of a Microsoft researcher asserting that e-mail scammers identify themselves as being from Nigeria (a well-known origin for such scams) to reduce their costs of identifying and luring viable

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183. *See* Guttentag, *supra* note 50, at 163–64 (describing the cost of "regulatory waste").

184. *See supra* notes 145–46 and accompanying text (describing how sorting may reduce fraud and improve information).

185. Studies suggest that targets of securities fraud have relatively high incomes compared to the general population and victims of other types of fraud, supporting the intuition that a fraudster will prefer deep pockets to maximize payoffs. KARLA PAK & DOUG SHADEL, AARP FOUNDATION NATIONAL FRAUD VICTIM STUDY 4 (2011).

186. *See* STEVEN D. LEVITT & STEPHEN J. DUBNER, THINK LIKE A FREAK 154–61 (2014) (describing research by Cormac Herley).

victims.[187] By responding to an e-mail originating from Nigeria, the potential victim self-identifies as gullible or uninformed about email scams.[188] Analogously, the accredited-investor concept may help perpetrators of securities fraud efficiently target deep-pocketed victims by legitimizing inquiries into wealth. In some cases, the current regulatory scheme even encourages wealthy investors to helpfully serve themselves up on a silver platter by organizing into standing databases of accredited investors.[189]

Investor protections are also predictably weakened when scaled disclosure produces the wrong information and sorting fails to identify incapable investors. Investors are not aided in satisfying their preferences—in fact, some preferred investments are made too expensive by arbitrary disclosure requirements and some perfectly capable, but not wealthy, investors are excluded from the market altogether. Such a regime also does little to stop incapable investors from making mistakes and perhaps emboldens some wealthy but unsophisticated investors by deeming them accredited.

Table 3 summarizes the weak performance of ineffective smart-money approaches across all goals of securities law.

C. The Case for Investment Caps (Mad Money)

Of course, the fact that scaled disclosure and sorting are difficult to implement does not by itself mean those mechanisms are inferior to investment caps and other portfolio mechanisms.

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187. *See id.* at 157–59 (describing the costs of luring victims and of "false-positives"); Herley, *supra* note 153 (discussing the costs to a scammer of identifying victims).

188. *See* LEVITT & DUBNER, *supra* note 186, at 159–61 (discussing how scammers cause gullible victims to reveal themselves).

189. For example, a company named American Direct Marketing Services, Inc. offers access to such a database. *ADMS' Accredited Investors*, ADMS, http://www.dmlist.com/direct-mail-telemarketing-lists/adms'-accredited-investors#sthash.6nxWh6Di.dpuf (last visited Nov. 19, 2014) (on file with the Washington and Lee Law Review). In promoting sale of the list, the site explains: "$1,000,000 minimum net worth separates the Accredited Investor from the other 96.4% of America's investing public. ADMS' Accredited Investor database will position the financial services marketer in a specifically attractive universe of high net worth investors and major market players capable of making five and six figure investments." *Id.*

To make the case for portfolio mechanisms, one has to show that they are less affected by universality than smart-money approaches. To that end, this Part V.C considers how investment caps perform when taking into account implementation challenges posed by universality.

With respect to the goals of capital formation, investor-choice protection, and populist protection, it is hard to see how the broad scope of private placement regulation has much effect. For example, recall that even a perfectly effective investment cap (one that ensures diversification and liquidity) has mixed effects on the goal of capital formation and the highly correlated goal of investor-choice protection. By its nature, a cap reduces some risk-preferring investors' range of choice and potentially drives up an issuer's cost of capital.[190] On the other hand, an investment cap also drives up the cost of fraud and may improve the overall quality of information.[191] Universality does not appear to change these results. Even a cap that totally fails in its objectives of diversification and liquidity still potentially increases the costs of both legitimate and illegitimate capital raising. These steady results stand in contrast to the current accredited-investor definition, which in theory reduces incentives to defraud but, in fact, may create a perfect storm of wealthy and unsophisticated investors without substantial protections.[192]

That is not to say that universality has no effect on investment caps. As described above, the strength of an effective investment cap is its strong paternalistic protection of investors through diversification and liquidity.[193] Universality is likely a significant, but not insurmountable, challenge for achieving meaningful diversification.

Because of universality, a simple investment cap encourages only modest diversification and does not ensure the greater benefits achievable through a sophisticated asset allocation strategy. Finance professors and securities professionals suggest that an optimal investment portfolio would not only include

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190. *Supra* note 152 and accompanying text.

191. *Supra* notes 153–54 and accompanying text.

192. *See supra* notes 185, 189 and accompanying text (discussing how current regulations affect incentives to defraud).

193. *Supra* notes 128–31 and accompanying text.

investments in several different companies, but also investments in different industries, asset classes (stocks, bonds, and cash), and geographic markets (U.S. and non-U.S.).[194] In other words, an investor whose entire asset portfolio consists of stock in fifty social media startups headquartered in Palo Alto is not as well diversified as an investor who spreads fifty investments over companies of varying sizes, industries, and geographic location. The goal of a sophisticated asset allocation strategy is to hold a large number of investments with low "covariance," meaning the investments do not have parallel returns.[195]

The importance of covariance is often illustrated through the type of highly stylized example that follows.[196] Assume that an investor plans to purchase $100,000 of Security A sold in a private placement. Assume that on average Security A has a positive expected return but that it is risky (volatile) in the sense of having potential for either big losses or big gains.[197] Now suppose the investor has the opportunity to instead invest half of the $100,000 in a new security. If the value of the new security is perfectly positively correlated with Security A, so that the new security increases and decreases in value in parallel to Security A, the investor will not decrease risk through diversification.[198] In contrast, the investor can eliminate risk altogether if the new security is perfectly negatively correlated with Security A, so that the new security always declines in value when Security A

194. *See* MALKIEL, *supra* note 46, at 206–14 (discussing the benefits of diversification); DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO INVESTING 16–17, 22 (same); THE VANGUARD GROUP, INC., VANGUARD'S PRINCIPLES FOR INVESTING SUCCESS, 12–16 (2014) http://www.vanguard.com/pdf/s700.pdf (discussing the benefits of diversification across asset classes).

195. *See* MALKIEL, *supra* note 46, at 204 (describing the concept of covariance); SWENSON, *supra* note 194, at 16–17 (explaining the importance of diversification).

196. *See* MALKIEL, *supra* note 46, at 202–06 (explaining modern portfolio theory through the example of an island economy with two potential investments); *Risk and Return: Diversification*, COLUMBIA BUS. SCH. PREMBA FIN., https://www0.gsb.columbia.edu/premba/finance/s6/s6_5.cfm (last visited Nov. 19, 2014) (providing an example of a two-stock portfolio) (on file with the Washington and Lee Law Review).

197. *See* MALKIEL, supra note 46, at 196–202 (identifying volatility as a measure of financial risk).

198. *Id.* at 202–06.

increases in value and the new security always increases in value when Security A decreases in value.[199] It is hard to imagine such perfect positive correlation or perfect negative correlation, and real-life examples fall somewhere in between.[200] The important point is that diversification will provide *some* risk reduction at anything less than perfect positive correlation, but a more effective diversification strategy requires judgments about the degree of correlation between investments.[201] This discussion of covariance is good and bad news for investment caps. The bad news is that optimal diversification would require regulators to categorize every potential investment and to understand its relationship to every other asset held by the investor. The broad range of investment types that private placement regulations encompass likely renders this task impossible. But the good news is that imperfect diversification still makes a difference.[202] Ensuring that no single investment in a private placement dominates an investor's portfolio is a sound, if modest, objective.

Furthermore, an investment cap's other objective of liquidity seems mostly unfazed by universality. It is reasonable to presume that any private placement is going to be relatively hard to convert into cash. This is a valid presumption across all types of private placements because illiquidity is a regulatory consequence of private placement status, rather than an intrinsic quality that differs across investment products. Under applicable law, securities initially sold in private placements cannot be

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199. As an example of negatively correlated investments, a leading corporate finance text discusses a hypothetical beach resort that thrives on sunny days and raincoat factory that thrives when it rains. *Id.* at 203.

200. *Id.* at 205.

201. *Id.* at 206 ("Now comes the real kicker; negative correlation is not necessary to achieve the reduction of benefits from diversification."). The marginal effect on volatility decreases with each security added. *See id.* at 207. Some suggest that the bulk of diversification's benefits are achieved with a portfolio of approximately fifty stocks, assuming the portfolio is limited to U.S. equities. *See id.* (summarizing various studies). Others suggest that a larger number of stocks is necessary for optimal diversification. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 3.3.6 n.81 (2d ed. 2008) (reviewing evidence that most investors are not diversified).

202. *See* MALKIEL, *supra* note 46, at 576 ("[A]nything less than perfect positive correlation can potentially reduce risk.").

resold freely on securities markets.[203] They are therefore illiquid by law.

Of course, liquidity is a relative concept and it is conceptually possible that a particular private placement investment would improve liquidity of a particular investor's portfolio because the investor's beginning position is extremely illiquid. But data on household wealth suggests that this scenario is unlikely. The major categories of assets that most American families report owning—real estate[204] and retirement accounts[205]—fall somewhere in the middle of the liquidity spectrum. One can often sell or borrow real estate, though with delay and expense; one can also borrow against or withdraw from many types of retirement plans, though usually with tax penalties.[206] While reducing these commonly held assets to cash is not effortless, it is hard to see how adding private placements to the mix likely improves liquidity.

In sum, this analysis confirms the intuition that containing risk through investment caps has practical advantages over trying to engineer each transaction to be safe. Like securities professionals who categorize private placements as "alternative" or "non-core" assets that should represent only a limited portion (0% to 25%) of an investor's portfolio,[207] investment caps

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203. *See supra* notes 130–31 and accompanying text (describing restrictions on re-sale).

204. *See infra* note 217 and accompanying text (describing census data regarding household wealth).

205. The Federal Reserve collects data on financial asset ownership. U.S. Fed. Reserve Bd., *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Fins.*, 98 FED. RESERVE BULLETIN 24–31 (June 2012), http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf. With 50% of households reporting ownership of a retirement account, such accounts are the second most commonly held financial asset, with only transaction accounts (i.e., bank accounts) ranking higher. *Id.* Retirement accounts average 38% of household wealth. *Id.*

206. *See* Janet Novack, *11 Ways To Tap Retirement Cash Early, Without a 10% Penalty*, (Jan. 15, 2013, 3:56 PM) http://www.forbes.com/sites/janetnovack/2013/01/15/11-ways-to-tap-retirement-cash-early-without-a-10-penalty/ (last visited Nov. 19, 2014) (recommending strategies to withdraw retirement funds without tax penalties) (on file with the Washington and Lee Law Review).

207. *See* SWENSEN, *supra* note 194, at 92–93 (discussing non-core asset classes, such as investments in venture-capital funds); HESHELOW, *supra* note 162, at 92–93 (describing oil and gas partnerships as alternative asset classes); U.S. TRUST, ASSET ALLOCATION AND ANGEL INVESTING (Feb. 24, 2005) (describing

recognize that risk ultimately depends not only on the characteristics of a particular security but also its place in a broader investment portfolio. By setting some basic parameters for investors' portfolio construction, Congress and the SEC can provide modest yet meaningful risk mitigation without perfect knowledge.

V. A Proposal

The first four Parts of this Article made the case for investment caps. Though effective smart-money approaches have theoretical advantages over investment caps, sorting and scaled disclosure are difficult to implement over the broad range of investment products to which private placement regulations apply. This problem of universality suggests that investment caps should constitute the core of private placement regulations. This Part outlines a specific proposal for implementing investment caps, and then addresses potential objections.

A. The Scope

The investment-cap proposal outlined below would replace safe-harbor exemptions in current Regulation D, including but not limited to Rule 506. As a safe-harbor exemption, the proposal would not be the exclusive means to avoid registration obligations under the '33 Act. An issuer could complete a transaction in excess of the investment cap and still take the position that the sale complied with Section 4(a)(2) of the '33 Act and related case law because of the purchaser's clear ability to fend for itself. In this vein, publicly traded companies frequently issue debt to institutional investors in private placements.[208] Under current

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angel investments as alternative investments and suggesting that alternative assets represent 0–25% of an investor's portfolio, private equity represent 20–60% of alternative investments, angel investments represent no more than 50% of private equity, and the amount allocated to angel investing should be divided among 5 to 10 individual investments) (on file with the Washington and Lee Law Review).

208. *See* Guttentag, *supra* note 50, at 151 n.125 (explaining the private debt market and the disclosure demands of participating investors).

law, issuers do sometimes rely on the Rule 506 safe harbor for these transactions, but in other instances issuers take the position that these transactions comply with Section 4(a)(2) without expressly relying on the safe harbor.[209] Similarly, the proposal does not preclude reliance on Section 4(a)(2) when there is no significant question about the ability of purchasers to fend for themselves, such as sales of stock to venture-capital funds and corporate-debt offerings to institutional buyers. The proposal will have its greatest effect on modestly sized offerings to individuals, where the Regulation D safe harbors have their greatest value because sophistication of the purchasers is less certain and litigation risk is higher.[210]

Moreover, the proposal does not preclude use of scaled disclosure and sorting in future safe harbors. Those mechanisms may have a role in exemptions that are limited to specific investment contexts or products. For example, I previously proposed an exemption specifically tailored to angel investments in startup companies.[211] The exemption would have employed

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209. These offerings are often referred to as "144A offerings." *See* LLOYD S. HARMETZ, MORRISON FOERSTER, FREQUENTLY ASKED QUESTIONS ABOUT RULE 144A, at 1 (2009), http://media.mofo.com/docs/pdf/faqrule144a.pdf. (providing a general overview of Rule 144A). Rule 144A exempts *resales* of securities to "qualified institutional buyers" who meet financial standards far more demanding than accredited investor status. *See id.* (describing qualifications for investment in Rule 144A offerings). Because 144A is an exemption for resales (but is not available to issuers for initial sales), a 144A offering first relies on either § 4(a)(2) or Rule 506 for an initial sale (often to a financial intermediary) and then Rule 144A for subsequent resales. *See id.* ("Any person other than an issuer may rely on Rule 144A. Issuers must find another exemption for the offer and sale of unregistered securities. Typically they rely on Section 4(2) (often in reliance on Regulation D) or Regulation S under the Securities Act."); SCOTT BAUGUESS & VLADIMIR I. IVANOV, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION 2 (2012) (suggesting that the first leg of a 144A exemption typically relies on Section 4(a)(2)).

210. *See* BAUGUESS & IVANOV, *supra* note 209, at 3, 11–12 (reporting, based on an empirical study of Form D filings, that Regulation D is most frequently used for offerings of below $2 million by non-financial issuers, though large offerings by financial issuers do account for a large percentage of the total dollar value of Regulation D offerings).

211. The proposed exemption would have been available only to privately held operating companies—not publicly traded companies conducting PIPE offerings, real estate partnerships, hedge funds, or similar investment vehicles. *See* Cable*, supra* note 4, at 168–72 (explaining the scope of the proposed reform).

sorting mechanisms based on a profile of angel investors with demonstrated success in mitigating the challenges of investing in startup companies.[212] Policy makers should continue to consider such context-specific exemptions where possible—this Article recognizes that *effective* smart-money approaches may have advantages over investment caps. It would be impractical, however, to rely on a collection of context-specific exemptions as the only safe harbors from registration. Investment products come, go, and evolve, and we cannot wait for Congress or the SEC to address each investment product separately.

B. The Details

While this Article's analysis points in the general direction of investment caps, the devil will always be in the details. In that spirit, this subpart outlines a more specific proposal. The proposed cap would subject an investment to two separate tests: one to encourage diversification and one to encourage liquidity.

1. A Diversification Test

An investor would be considered diversified if he or she limited a particular private placement investment to a specific percentage (2.5%, for example) of the investor's *gross* assets.

Use of gross, as opposed to net, assets is a departure from current investment caps.[213] The proposal takes this approach because high levels of debt, while posing some potential risk to

212. The proposal would have eliminated the ban on general solicitation and relieved intermediaries (such as "finders") from broker–dealer or investment adviser regulation so long as all investors met both the current accredited investor standard and at least one additional qualification. *Id.* The additional qualifications included experience as an investor or experience as an entrepreneur, reflecting the important role that entrepreneurial (as opposed to financial) experience appears to play in selecting angel investments. *Id.* Entrepreneurial experience would have been demonstrated by participation in a Rule 506 offering as an executive officer of the issuer, while financial experience would have been demonstrated by ownership or management of at least $1.5 million in investments (roughly corresponding to the average angel investor portfolio). *Id.*

213. *See supra* notes 124–27 and accompanying text (describing investment caps under current law).

investors, are not necessarily relevant to whether an investor is appropriately diversified.[214]

This diversification test also departs from the JOBS Act cap by applying only to the amount purchased from a particular issuer, rather than imposing an aggregate cap for all private placements.[215] For diversification purposes, the primary focus is dividing purchases among different issuers; any limit on aggregate exposure to private placements is better addressed under the liquidity test below.

One can imagine a more sophisticated diversification measure that would take into account covariance.[216] Such a measure would require categorizing not only the new investment, but also the existing assets of the purchaser that serve as the "denominator" for purposes of the specified percentage. For instance, census data on household wealth indicates that ownership of personal residences and investment real estate represent a significant portion of most Americans' asset portfolios.[217] The proposed exemption could disqualify such real estate holdings as denominator assets for purposes of real-estate-based private placements (such as limited partnerships for developing and operating real estate projects) to encourage diversification across asset classes. Ultimately, however, it seems

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214. For example, Ian Ayres and Barry Nalebuff suggest that young investors borrow to enlarge their stock portfolios, partly on diversification grounds. *See* IAN AYRES & BARRY NALEBUFF, LIFECYCLE INVESTING: A NEW, SAFE, AND AUDACIOUS WAY TO IMPROVE THE PERFORMANCE OF YOUR RETIREMENT PORTFOLIO 15–18 (2010) (proposing that young investors use leverage to diversify investment across time).

215. *See* 15 U.S.C. § 77d-1(a)(8) (2012) (applying the crowdfunding investment cap on an aggregate annual basis); *supra* note 10 (discussing the aggregate investment cap).

216. *See supra* note 195 and accompanying text (describing the concept of covariance and its importance to diversification).

217. *See* ALFRED O. GOTTSCHALCK, U.S. CENSUS BUREAU, NET WORTH AND THE ASSETS OF HOUSEHOLDS: 2002, at 1 (2008), http://www.census.gov/prod/2008pubs/p70-115.pdf ("[A]s home ownership rates climb, more and more households can claim their homes as a source of wealth and, in the majority of cases, as their predominant asset."). According to 2002 census data, 67.7% of households include equity in their own home among their reported asset holdings. *Id.* at 5 tbl.1. The median value of such equity is $73,697. *Id.* A much smaller percentage of households report owning rental property (4.5%) and other real estate (6.6%), though the median reported value of these asset types is relatively high ($100,000 and $45,000, respectively). *Id.*

likely the benefits of such refinements to the diversification test are outweighed by the associated administrative challenges. Issuers, investors, and regulators are not accustomed to classifying assets in this manner and in some cases there may not be adequate information for making reasonable assumptions about covariance. In contrast, participants in private placements are accustomed to determining asset value more generally as part of verifying accredited-investor status.[218] In order to avoid self-defeating administrative complexity, the proposal uses a simple diversification measure based on the purchaser's total assets, regardless of the nature of those assets.

2. A Liquidity Test

An investor could demonstrate ability to bear illiquidity either through asset holdings or annual income. For the asset test, net (as opposed to gross) wealth is a sensible measure. To the extent that assets are encumbered by debt, those assets are less likely to be available for satisfying current obligations. In addition to net assets, high annual income suggests the capacity to hold illiquid private placements. Therefore, like the investment cap in the new crowdfunding exemption, the liquidity test would require that an investment not exceed the higher of: (1) a specified percentage of net assets, or (2) a specified percentage of annual income.[219] In the absence of compelling reasons to pick a different number, the specified percentage could be 10%, similar to the current crowdfunding exemption.[220]

As with the diversification measure, one could imagine more or less elaborate liquidity tests. It seems advisable to exclude other private placements as denominator assets for a net assets test, due to the inherent illiquidity of private placements. In theory, regulators could go further and classify all assets by relative liquidity and weigh them accordingly. For example,

218. *See infra* note 238 and accompanying text (discussing SEC guidance on verifying accredited-investor status).

219. *See supra* notes 124–27 and accompanying text (discussing the assets and income in the crowdfunding exemption).

220. *See supra* notes 124–27 and accompanying text (discussing the percentage thresholds in the crowdfunding exemption).

primary residences and retirement accounts with tax penalties for withdrawals could be disqualified or discounted as denominator assets based on their relative illiquidity.[221] As with more elaborate diversification measures, the additional administrative complexities of these more elaborate liquidity measures likely outweigh the benefits. Accordingly, the proposal uses a liquidity test that could be satisfied based on income or net assets, with only private placements excluded as denominator assets.

C. Competing Proposals

Since the JOBS Act was enacted, others have suggested a modest additional role for investment caps. These competing proposals graft investment caps onto the existing regulatory framework by incorporating them into the current accredited-investor definition.[222] The result is that an issuer would gain significant regulatory freedom under Rule 506 if: (1) all purchasers meet threshold income and net worth standards similar to those currently employed in the accredited-investor definition and (2) purchasers also comply with an investment cap

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221. *See supra* note 206 and accompanying text (discussing relative liquidity of commonly held assets).

222. *See* Larissa Lee, Note, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 UTAH L. REV. 369, 386–88 (2014) (proposing modification of the accredited-investor definition to include adjusted wealth standards, an investment cap based on net assets or income, and subjective sophistication assessment); Oguss, *supra* note 158, at 310–18 (proposing modification of the accredited-investor definition to adjust wealth standards for inflation and impose an investment cap of 25% of net assets, with a phase-out of the investment cap at some multiple of the wealth standards). Most recently, the SEC's Investor Advisory Committee recommended changes to the accredited-investor definition. The committee made a variety of recommendations, including financial literacy testing, facilitation of third-party investor-status verification, and investment caps. For illustrative purposes, the committee outlined an approach that would retain existing wealth standards as a minimum threshold for accredited-investor status, with an additional investment cap based on net assets or income that would phase out at some higher wealth standard. *Recommendations of the Investor as Purchaser Subcommittee and the Investor Education Subcommittee: Accredited Investor Definition*, INVESTOR ADVISORY COMM., http://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml (last visited Sept. 30, 2014) [hereinafter *Advisory Committee Recommendations*].

limiting their individual investments to a percentage of their net assets or income. By limiting reforms to the accredited-investor definition, current avenues for sales to non-accredited investors would remain intact.[223] This Article departs from these competing proposals in several respects.

First, because this Article's proposal completely replaces Regulation D with investment caps, it eliminates current exemptions under Regulation D that allow sales to non-accredited investors in small offerings or after scaled disclosure. As discussed in Part IV.B.1 above, scaled disclosure is unlikely to provide investors with helpful information across a wide range of investment products, so this Article removes scaled disclosure from the core safe-harbor exemption and reserves that mechanism for context-specific exemptions where more meaningful disclosure standards might be possible.[224] This Article also recommends eliminating the exemption in Rule 504 for small offerings ($1 million or less) on the logic that a small offering size can still cause significant losses if concentrated in a small number of investors.[225]

Second, because this Article's proposal completely replaces the concept of an accredited investor with the investment cap, it eliminates wealth thresholds of the type currently used in the accredited-investor definition. If wealth thresholds are a poor measure of financial sophistication or the ability to bear risk, as the bulk of commentary suggests,[226] it is unclear what work they are doing in the regulatory scheme besides arbitrarily limiting the pool of eligible investors. If wealth thresholds are supposed to

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223. *See, e.g.*, 17 C.F.R. § 230.504 (2014) (setting forth Rule 504 of Regulation D, which allows sales to non-accredited investors if the total offering amount does not exceed $1 million); *id.* § 230.505 (setting forth Rule 505 of Regulation D, which allows offerings up to $5 million to non-accredited investors after provision of audited financials and specified information); *id.* § 230.506 (setting forth Rule 506 of Regulation D, which allows sales to up to 35 sophisticated, but non-accredited, investors after provision of audited financial statements and other specified disclosure).

224. *See supra* Part IV.B.1 (discussing failures of scaled disclosure); *supra* notes 211–12 and accompanying text (discussing the possibility of context-specific exemptions based on scaled disclosure and sorting).

225. *See supra* note 223 (describing Rule 504).

226. *See supra* note 158 (citing sources that are critical of the current accredited-investor definition).

be a proxy for access to professional advice, then they are not well-suited to the objective, as discussed further below.[227] This Article takes the position that small investors should be permitted to risk a small amount of their small wealth, consistent with the goal of populist investor protection.

Third, this Article's proposal employs a two-part test specifically tailored to the dual goals of diversification and liquidity. As discussed above, gross rather than net assets are the logical denominator for achieving diversification.[228] In addressing liquidity concerns, net assets or income are the appropriate measure, but private placements should not be counted as denominator assets.[229] Without adding much administrative complexity, investment caps can be better suited to the relevant objectives than they have been in the past.

To an extent, the modest approach of competing proposals might be chalked up to understandable pragmatic considerations. In the case of recent work by an SEC advisory committee, the scope of the recommendations was largely set by statutory mandate.[230] Incremental and more easily won proposals also play an important role in legal scholarship.[231]

But, it is also important to avoid past mistakes in simply piling on additional regulatory mechanisms without scrutinizing their fit for the job. There is a cost to regulatory clutter—poorly constructed exemptions can become counterproductive and obscure analytical clarity. A systematic analysis of the goals of private placement regulation and current mechanisms suggests a significant change in direction, with investment caps at the core of the regulatory scheme and current smart-money approaches at the periphery. More incremental reforms risk obscuring this broader insight.

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227. *See infra* note 249 and accompanying text (discussing access to investment advice).

228. *Supra* notes 213–14 and accompanying text.

229. *Supra* notes 220–21 and accompanying text.

230. *See Advisory Committee Recommendations*, *supra* note 222, at 2 (referencing the SEC's statutory mandate to review the accredited-investor definition).

231. *See* Harry T. Edwards, *The Growing Disjunction Between Legal Education and the Legal Profession*, 91 MICH. L. REV. 34, 55 (1992) (criticizing legal scholarship for making too many impractical reform proposals).

D. Potential Objections

Any significant reforms will have drawbacks and detractors. This subpart anticipates and responds to potential objections.

1. Diversification to Lower Quality

An individual investor may have access to relatively few quality private placements, and the investment cap may push that investor to lower quality investments. For example, an investor with $2 million in total assets may plan to invest $200,000 in a startup launched by a trusted former colleague and friend, but the proposed investment cap might limit investment to $50,000. The investor might invest the remaining $150,000 in startups founded by strangers. Dividing the investment among four companies, rather than the one trusted entrepreneur, may expose the investor to higher transaction costs (because the investor may take additional steps to verify information) and increased chance of opportunistic behavior (because strangers are subject to weaker reputational constraints).

Without empirical research testing the effects of caps, it is difficult to rule out this possibility altogether. But there are good reasons to suspect a different result. Investment in private placements is not as common as investment in real estate, public equities, investment funds held in retirement accounts, certificates of deposit, and life insurance products.[232] One would expect the hypothetical investor to turn to these more accessible asset classes rather than stretching to find additional private placements.

232. *See supra* note 217 (discussing the number of households that report owning real estate); Fed. Reserve Bd., *supra* note 205, at 24–31 tbl. 6 (reporting that the following percentages of households own the following investment products: retirement accounts, 50%; life insurance with cash-surrender value, 20%; publicly traded stock, 15%; savings bonds, 12%; and certificates of deposit, 12%).

2. Death by a Thousand Cuts

One might object that this Article's proposal, when compared to the current Rule 506, simply spreads losses around so that all investors suffer a little instead of a few investors suffering a lot. One might ask: what is achieved by shuffling around losses?

First, modern portfolio theory suggests that where we situate risk matters greatly. Except in the rare case of perfectly correlated performance, the impact of an individual security's risk is reduced when combined with other securities.[233]

Second, this Article posits that investment caps may, over time, improve information by reducing incentives to defraud. In other words, individual outcomes may improve as high-quality issuers are better able to distinguish themselves.[234] In contrast, the current accredited-investor concept may create the perfect storm for fraud and misinformation by lifting protections for wealthy but unsophisticated investors.[235]

In sum, both a static view (assuming the reform simply redistributes failed investments) and a more dynamic view (asserting that investment caps will reduce fraud over time) suggest that reshuffling matters.

3. Asset Verification Problems

This Article eschews more complex diversification and liquidity standards for administrative ease, but the proposal still depends on relatively accurate estimates of asset values. One might object that the burdens of asset verification will make the exemption unattractive (if the verification process is too strict) or ineffective (if the process is too lax). [236]

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233. *See supra* notes 194–202 and accompanying text (discussing diversification and covariance).

234. *See supra* note 154 and accompanying text (discussing incentives for fraud).

235. *Supra* note 189 and accompanying text.

236. For a thoughtful discussion of verification issues relating to the crowdfunding exemption, see J. Robert Brown, Jr., *Selling Equity Through Crowdfunding: A Comment*, U. Denver Legal Studies Research Paper No. 14-11, *available at* http://ssrn.com/abstract=2386278 or http://dx.doi.org/10.2139/ssrn.2386278 (Jan. 27, 2014).

This same objection could be raised in regard to current sorting methods. The accredited-investor definition requires calculation of net assets and income,[237] just like this Article's proposal. Because the JOBS Act increased the importance of the accredited-investor standard, the SEC recently promulgated new guidance regarding acceptable asset and income verification methods. The SEC suggests, but does not require, review of tax documents, account statements, and certifications by securities professionals.[238] The proposed investment cap could adopt this existing framework.

4. Human Capital

For many individuals, their greatest investment is human capital—the skills, experience, and education on which their livelihood is based.[239] This Article's proposal does not take human capital into account when calculating the cap.

To an extent, this is just another tradeoff between more effective diversification and administrative ease. One could try to put a value on an investor's human capital, attempt to establish the degree of correlation between that value and the type of private placement in question, and adjust the cap accordingly. But the administrative and theoretical difficulty of doing so would be considerable,[240] so this Article's proposal settles for less effective diversification.

In limited circumstances, adding human capital to the equation could render an investment cap counterproductive. For example, an employee of a semiconductor company may be heavily invested in his or her employer's stock, and investment in an oil and gas partnership, even in amounts above the

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237. *See* 17 C.F.R. § 230.215(e)–(f) (2014) (setting forth the definition of an accredited investor).

238. 17 C.F.R. § 230.506(c)(2)(ii) (2014).

239. *See* MALKIEL, *supra* note 46, at 228 (identifying human capital as an important asset); William K. S. Wang, *Some Arguments That the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 371 (1986) (discussing human capital in the context of the capital-asset pricing model); John F. Wasik, *The Biggest Financial Asset in Your Portfolio Is You*, N.Y. TIMES, Feb. 12, 2013, at F7 (asserting that human capital is often one's most important asset).

240. *See id.* (discussing the difficulty of valuing human capital).

investment cap, might be helpful on diversification grounds because the investor started from such an undiversified position. But such an investor's "diversification" strategy of sinking a large percentage of wealth into a single illiquid private placement leaves a lot to be desired. An investment cap may still have benefits if it prompts the investor to rethink the proposed investment and instead consider the more liquid and diversified investment products readily available in today's marketplace.[241]

5. Empirical Uncertainty

This Article's analysis is based on evidence where possible.[242] But, some of its conclusions necessarily rest on empirically untested estimations of costs and benefits, such as whether sorting or investment caps improve overall information in the market by reducing incentives to defraud.

Hopefully, this Article can serve as a starting point for future empirical research. But it is also important to recognize that empirical consensus takes time, and the dysfunction of current exemptions may justify regulatory experimentation sooner rather than later. In recent decisions, courts overturned rulemaking by second guessing how the SEC weighed competing empirical evidence.[243] Regulatory policy may suffer if the SEC must wait for empirical researchers to complete relevant work, let alone reach a consensus. In some cases, adapting to the market may require playing a regulatory hunch and expanding apparently successful initiatives.[244]

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241. *See supra* note 232 and accompanying text (discussing typical investment assets).

242. *See, e.g.*, *supra* notes 217, 232 (citing data on household wealth); *supra* notes 156, 210 (citing evidence regarding use of Regulation D).

243. *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144, 1151 (D.C. Cir. 2011) ("In view of the admittedly (and at best) 'mixed' empirical evidence, we think the [Securities and Exchange] Commission has not sufficiently supported its conclusion . . . ." (citation omitted)).

244. For example, in 1988 the SEC created a registration exemption specifically for stock option grants, apparently to accommodate emerging Silicon Valley compensation practices. *See* Compensatory Benefit Plans and Contracts, 53 Fed. Reg. 12, 918-02 (Apr. 20, 1988) (to be codified at 17 C.F.R. pts. 200, 230, 239) (announcing the adoption of Rule 701 and referencing startup companies). The SEC then gradually expanded the exemption as it functioned without

6. Why Protect the Rich?

The proposed investment cap does not phase out at any income level. This is in part because it is assumed that issuers making sales to elite investors can rely on § 4(a)(2) of the '33 Act and related case law, rather than the proposed safe harbor.[245] Still, one might ask whether private placement regulation should more definitively phase out at some level of wealth.

First, there is a doctrinal answer to this question. The '33 Act charges regulators with protecting investors without reference to wealth.[246] And historically, case law interpreting the '33 Act has based exemption on the investors' ability to "fend for themselves," not their ability to absorb loss.[247]

Second, this Article suggests sound policy reasons for protecting the wealthy and unsophisticated. Their gullibility may have spillover effects by chumming the waters for fraud.[248]

That said, regulatory resources are scarce, and it may be reasonable to leave the protection of the wealthiest to professional advisers. In that case, any wealth standard should be based on an informed judgment about the availability of quality investment advice. For example, many investment advisers require that a minimum value of assets be placed under the adviser's management.[249] If private placement regulation phases out, the threshold should be based on having assets in an amount and of a type consistent with these customary minimums.[250]

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notable abuse of stock option recipients. *See* MAYNARD & WARREN, *supra* note 115, at 244 (discussing the expansion of Rule 701 in 1999).

245. *See supra* Part V.A (describing the scope of the proposal).

246. *Supra* note 40 and accompanying text.

247. *Supra* notes 106–08 and accompanying text.

248. *See supra* text accompanying notes 145–46 (discussing potential negative spillover effects of unsophisticated investors).

249. *See* Marla Brill, *How to Afford an Investment Adviser Without Breaking the Bank*, REUTERS (Dec. 13, 2011, 11:09 AM), http://www.reuters.com/article/2011/12/13/us-usa-investing-adviser-idUSTRE7BC1AN20111213 (last visited Nov. 19, 2014) (discussing traditional and emerging fee structures for investment advisers) (on file with the Washington and Lee Law Review).

250. For example, one of the competing proposals discussed above includes a phase-out of the investment cap at a certain net asset value based on availability of professional advice. *See* Oguss, *supra* note 158, at 285. But a threshold based on the size of the individual's investible assets (those capable of

VI. Conclusion

We continue to view private placement regulation as an important lever for economic recovery and growth, but we are frustrated by policymakers' inability to find the elusive balancing point between capital formation and investor protection. The existing discourse suggests that setting private placement policy should be like adjusting a carburetor. When private placements are too strict, we starve the economy of important fuel. When regulations are too lenient, we fail to protect investors by flooding them with aggressive and manipulative offerings. We expect that a skilled regulator or legislature, like a skilled mechanic, will eventually find the perfect balancing point.

This Article suggests the concepts of capital formation and investor protection, their relationship to each other, and their relationship to specific regulatory policies are more complicated than the existing discourse suggests. A more nuanced analysis produces a surprising result. Investment caps—found in an obscure provision of a mostly ineffectual set of reforms—should be the foundation of private placement regulation.

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being put under management of an adviser, such as stocks, bonds, and cash) would be better tailored to this rationale.

Table 1
Relationship Between
Capital Formation & Investor Protection

	Investor-Choice Protection	**Paternalistic Protection**	**Populist Protection**
Capital Formation	Aligned Facilitates mutually beneficial transactions by addressing info asymmetry	Ambiguous Relationship • <u>Tension</u>: Reduces sources of financing • <u>Aligned</u>: Boosts investor confidence	Ambiguous Relationship • <u>Tension</u>: Sacrifices efficiency for fairness (*e.g.,* insider trading?) • <u>Aligned</u>: Broadens participation in capital markets

Table 2
The Mechanisms in Theory

	Capital Formation	**Investor Protection**		
		Investor Choice	Paternalistic	Populist
Smart Money (e.g., scaled disclosure & sorting)	Strongly[251] Encourages investing by: • Optimizing information • Disincentivizing fraud	Strongly Facilitates investor preferences by: • Optimizing information • Disincentivizing fraud	Strongly Prevents incapable investors from making mistakes	Weakly Excludes some investors altogether

251. A mechanism is *strongly* aligned or consistent with a goal when it apparently advances the goal with no material and counter-productive side effects. A mechanism is *moderately* aligned with a goal when it arguably both advances and frustrates the goal and it is unclear which effect dominates. A mechanism is *weakly* aligned with a goal when it does not advance the goal in any appreciable way, or it frustrates the goal without materially advancing it at the same time.

Mad Money (e.g., investment caps)	Moderately • Encourages investing by disincentivizing fraud • Discourages investing by increasing issuer transaction costs	Moderately • Facilitates preferences by disincentivizing fraud • Constrains risk-preferring choices	Strongly Mitigates consequences of investor mistakes	Moderately Allows all investors some access

Table 3
The Mechanisms in Practice

	Capital Formation	**Investor Protection**		
		Investor Choice	Paternalistic	Populist
Smart Money (e.g., scaled disclosure & sorting)	Weakly Discourages investing by: • Mandating unwanted disclosure • Incentivizing fraud	Weakly Frustrates investor preferences by: • Mandating unwanted disclosure • Incentivizing fraud	Weakly Wealthy incapable investors not protected from mistakes	Weakly Some investors arbitrarily excluded from market
Mad Money (e.g., investment caps)	Moderately • Encourages investing by disincentivizing fraud • Discourages investing by increasing issuer transaction costs	Moderately • Facilitates preferences by disincentivizing fraud • Constrains risk-preferring choices	Moderately Somewhat mitigates consequences of investor mistakes	Moderately Allows all investors some access