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THE ROLE OF ATTORNEYS AND REGULATION D OFFERINGS

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

The Role Of Attorneys in Exempt Offerings

I am delighted to have the opportunity to address this conference today and, thank the American Law Institute for having invited me. I agreed to speak to you before I had formulated a precise idea of what would be the subject matter of my talk. When I actually began thinking about what I would say, I quite naturally focused on the theme of the conference and my initial reaction was "Oh, have I got to talk about Regulation D?" Not an atypical reaction from a former litigator. Mickey Beach of the Commission's staff assured me that I did not have to speak on Regulation D and that probably most of you would welcome a break from that subject. Notwithstanding Ms. Beach's assurances, I decided that, as this was billed as a conference on Regulation D, I would not break ranks but rather would share with you some of my concerns about the current use of that exemption and indicate my views on the role attorneys play or should play in the organization of exempt offerings.

The Securities Act of 1933 has always contained exemptions for private placements 1/ and for "small" offerings below a certain amount. 2/ The reason for these exemptions, of course, is that such transactions usually involved sophisticated investors like institutions and others who were viewed as not needing the protections of the mandatory disclosure provisions of the Act. 3/

1/ Securities Act of 1933, Pub. L. No 73-22, § 4(1), 48 Stat. 74, 77 (1933) (codified as amended at 15 U.S.C. 77d(2)).

2/ *Id.*, § 3(b), 48 Stat. 74, 76-77 (1933) (codified as amended at 15 U.S.C. 77c(b)).

3/ *See* *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-26 (1953).

Moreover, it was thought unnecessary to burden "small" offerings to limited numbers of people with the requirements of the Act where the benefits to the public are presumed to be remote. 4/ Although these two exemptions have always existed, the adoption of Regulation D 5/ changed the equation with respect to them in three ways.

First, through Regulation D, the Commission exercised the authority granted to it by Congress in 1980 6/ to raise the small offering exemption from $2 million to $5 million. At the same time, the Commission raised the ceiling from $100,000 to $500,000 for offerings in which no specific disclosures must be given to purchasers. Thus, Regulation D raised the old ceilings by 250 percent and 500 percent, respectively. The increase is even more dramatic when one considers that, until 1970, the small offering ceiling was $100,000 and, until 1978, was set at $500,000.

Second, Regulation D is designed to reduce uncertainty in the process of making a private placement. This is because Regulation D ties the private placement exemption to the sophistication of actual purchasers, rather than the sophistication of both purchasers and offerees. In addition, under Regulation D an issuer need not determine the ability of purchasers to bear the risk of their investment.

4/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

5/ Securities Act Release No. 6389 (Mar. 8, 1982).

6/ Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 301, 94 Stat. 2275, 2291 (1980) (codified at 15 U.S.C. 77c(b)).

Finally, Regulation D changes the equation because it makes the small offering exemption available to limited partnerships whereas its predecessor rule had been available only to corporations. These changes, taken together, made possible a major transformation in the way in which unregistered offerings of securities are organized and marketed. In particular, Regulation D has contributed to the increased marketability of tax shelter investments.

When Regulation D was first adopted in March 1982, probably few would have predicted the tremendous volume of offerings that would be made pursuant to the rule. In fiscal 1985, an estimated $50 billion in securities were issued under Regulation D. This compares with $275 billion in new issues registered with the Commission in that same year. 7/

I fully support the purposes behind Regulation D. Our nation's economy needs a vehicle by which adequate capital can be made available for small businesses. I also endorse efforts to reduce unnecessary regulatory burdens on legitimate private placements. Clearly, the Commission should not use its resources to regulate areas where the benefits of such regulation are likely to be marginal. I do, however, have some concerns with how Regulation D is sometimes applied in the marketplace.

First, I am somewhat disconcerted by the sheer volume of Regulation D offerings. When one considers the billions of dollars of securities issued pursuant to Regulation D, together

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7/ U.S. Securities and Exchange Commission, Fifty-First Annual Report 126 (1985).

with another $45 billion worth issued by U.S. issuers in 1985 that were exempt because they were sold to foreign investors 8/ and tens of billions more that were issued in reliance solely on the Section 4(2) 9/ exemption, one discovers that the volume of unregistered offerings has come to represent a significant portion of the total amount of securities offerings. Of course, it is difficult to give an accurate assessment of just how many unregistered securities are issued each year. As you can imagine, it is difficult to have a head count if you cannot take a census. In any event, the Commission's mandate directs it to oversee the capital raising activities of U.S. enterprises. One might question whether this can be done effectively when 30 to 50 percent of all new securities issued is not registered with the Commission. Quite naturally, this situation raises questions about the role to be played by our system of statutorily mandated disclosures where that system applies to less than two-thirds of all new issues. 10/ This is an issue that remains to be addressed, especially in the light of the growing internationalization of our capital markets, which may require us to be even more flexible about our disclosure requirements.

8/ Statement of John Shad, Chairman, U.S. Securities and Exchange Commission, Hearings Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce (Mar. 5, 1986).

9/ Securities Act of 1933, as amended, § 4(2), 15 U.S.C. 77d(2).

10/ If we took into account government securities, the percentage would be even less.

Second, I am concerned by the use of Regulation D under circumstances in which investors do need the protections of registration. As a law enforcement official, I see a substantial number of cases involving fraud and deception in connection with small, unregistered offerings. The number of fraud cases brought by the Commission is small in proportion to the total number of offerings, but the cases that the Commission sees may very well be the tip of a large iceberg. We all realize that for every enforcement action initiated by the Commission, a dozen more violations are not pursued at the federal level for one reason or another.

Finally, I am disturbed by a tendency of some to stretch Regulation D to fit situations to which it was not intended to apply. The Commission has seen, during my tenure, a number of cases in which a large enterprise essentially divides itself into a number of smaller related entities and markets interests in these smaller units under Regulation D or as statutory private placements. However, frequently the enterprise, if it is viable at all, is viable only as a whole. For example, a real estate developer may organize and serve as general partner to a number of limited partnerships. Each partnership may own separate properties, but if the properties are located in the same developments, or if the success of each partnership is dependent upon the continued financial well-being of the general partner, or if the partnerships are subject to substantially identical potential risks and prospects for success, a serious question is raised as to whether the limited partnerships are in fact separate enterprises.

A similar question of course can be raised with respect to certain oil and gas ventures. Often, one sees a promoter act as general partner to a series of drilling partnerships for which a single drilling company serves as contractor. In many cases, the properties to be explored are also adjacent to each other or nearby. Under these circumstances, it is likely that the drilling partnerships will all succeed or all fail together. Where this is the case, I question whether a promoter may properly offer interests in these drilling partnerships under a small offering exemption from registration.

The approach described above focuses on the financial interdependence of different entities and upon the commonality of management between two distinct entities. This is not a novel proposition. The Courts of Appeal for the Seventh and Ninth Circuits 11/ have adopted a theory of integration that recognizes that these factors are relevant to a determination of whether the registration requirements of Section 5 of the 1933 Act apply to a particular offering. In addition, the Commission's staff and commentators have recognized the importance of these factors to

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11/ SEC v. Holschuh, 694 F.2d 130 (7th Cir. 1982); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).

an analysis of whether Regulation D is available. 12/ These rules governing integration of different securities offerings, however, only work if they are conscientiously applied by issuers. While at the Commission, I have encountered numerous instances in which issuers and their counsel appear to have ignored the principles of integration in determining whether a particular offering is exempt from registration.

Before I proceed, I want to take a moment to explain why I feel that the integration issue is significant. Some commentators believe that the Commission's position with respect to integration unnecessarily restricts reliance on various exemptions. These commentators ignore the rationale behind the integration doctrine: protection of the integrity of the Commission's registration process. Without it, almost any offering can be broken down into discrete, exempt offerings. Moreover, we should not forget that we operate within the framework of a statutorily mandated disclosure system. The 1933 Act is premised upon an assumption that the registration process serves an important function. If that assumption is wrong, we should overhaul the statute, but we should not permit exemptions to swallow the universe by ignoring the integration doctrine. Moreover, the factors which I have just identified as relevant to determining whether related limited

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12/ See, e.g., Marshall C. Taylor (pub. avail. Apr. 6, 1979) (letter denying no-action position to related partnerships drilling for oil and gas on properties connected to the same underground reservoir); Subcommittee on Partnerships, Trusts and Unincorporated Associations, Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering, 37 Bus. Law. 1591, 1610-11 (1982).

partnership offerings are truly separate offerings or integral parts of a single enterprise are often factors that would be material to investors, but often are not adequately disclosed.

If, as I have suggested, Regulation D raises some problems in its application, the question then is what is or may be the solution to those problems. The first solution is to police the securities markets vigorously. Through the Commission's investigations, we can identify and prosecute those persons who take advantage of exemptions to hide material information from investors. The Commission now actively pursues failures to register securities. Last year, in fact, the Commission brought 61 cases alleging violations of the registration provisions. 13/ Most, but by no means all, of those cases also involved fraud or misrepresentations. The Commission should, and will, continue to bring cases for failure to register.

A second possible solution to this problem is for the Commission to engage in some finetuning of Regulation D to deal with the "continuous Regulation D offering." The ABA's Committee on Federal Regulation of Securities has proposed a safe harbor rule which would define the types of offerings by entities with common sponsors not subject to registration. 14/ I certainly see an advantage to establishing a more specific rule to govern this

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13/ U.S. Securities and Exchange Commission, Fifty-First Annual Report 5 (1985).

14/ Committee on Federal Regulation of Securities, Integration of Securities Offerings: Report of the Task Force on Integration, 41 Bus. Law. 595 (1985).

an advantage to establishing a more specific rule to govern this situation. However, I am not prepared to offer a definitive opinion on the proposed rule until I consider its impact more fully.

For now, whether Regulation D will meet its stated purposes without developing into a vehicle for inflicting serious damage on investors and investor confidence in the small issues and private placement markets may depend increasingly less on the Commission's enforcement and rulemaking efforts and more on the conscientiousness and integrity of private counsel.

In this regard, I view private counsel as having several specific responsibilities. For example, lawyers have a "due diligence" obligation in connection with the preparation of legal opinions on the availability of exemptions from registration. Both the Commission and the American Bar Association have issued statements concerning what is expected of counsel in such situations. In a 1962 release, the Commission stated:

> [I]t is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct. 15/

15/ Securities Act Release No. 4445 (Feb. 2, 1962).

As one might expect, the ABA's ethics opinion envisions a less searching inquiry by counsel, but it nevertheless makes it clear that an attorney has an obligation to verify the facts related to him by the client that formed the basis for the attorneys' opinion. 16/

The second obligation applies to tax opinions distributed to investors or referenced in offering materials. An attorney's obligations for those opinions are set forth in a regulation adopted by the Department of the Treasury. 17/ The ABA has also issued an ethics opinion on the matter. 18/ The Treasury regulation and the ABA's opinion both set forth circumstances under which counsel may not rely upon an issuer's factual representations. They also describe in general terms what kinds of legal analyses are required before an opinion can be considered adequate. Recognition of the obligation to adhere to these guidelines is critical as more and more tax shelters are organized and sold to the public outside the protective cloak of the registration provisions of the 1933 Act.

The third responsibility of course relates to an attorney's ethical obligation not to assist knowingly their clients in

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16/ ABA Comm. on Ethics and Professional Responsibility, Formal Op. 335 (1974).

17/ 31 C.F.R. 10.33.

18/ ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (Revised) (1982).

perpetrating a fraud. 19/ To my mind, that ethical responsibility needs little elaboration.

Beyond the specific duties which may arise in the context of issuing legal opinions as to the legitimacy of any claimed exemption from the 1933 Act, I believe that attorneys generally have responsibilities when they assist in the preparation of offering materials for use in exempt offerings.

First, counsel must investigate and test the accuracy and adequacy of offering materials. For offerings subject to the information requirements of Rule 502(b)(2), issuers must provide "the same kind of information" as would be required in a registered offering. 20/ In the case of a Regulation D offering, however, the offering materials are not reviewed by the Commission's staff. Therefore, sufficient assurance that the materials are adequate for purposes of Rule 502 can exist only if counsel for the issuer exercises independent judgment about the nature and extent of disclosures made. As former Commissioner Al Sommer put it in a speech some years ago,

> Lawyers are not paid in the amounts they are to put the representations of their clients in good English, or give opinions which assume a pure state of facts upon which any third-year law student could confidently express an opinion. 21/

19/ *See, e.g.*, Model Rules of Professional Conduct Rule 1.2(d) (1984).

20/ 17 C.F.R. 230.502(b)(2).

21/ A.A. Sommer, The Emerging Responsibilities of the Securities Lawyer, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,631, at p. 83,689 (Jan. 1974).

More to the point, as former Commissioner Frank Wheat recently commented at SEC Speaks, although in a different context, securities lawyers are the Commission's back up police force, its field agents, so to speak. We must and do rely on you to hold the line and ensure that your issuer clients comply with the law.

Before you rise in anger and attack, let me assure you that I am not saying that the Commission should view lawyers as the guarantors of the accuracy of their clients' representations or of the soundness of the investment opportunities they offer. There is no need to adopt such a radical position. The plaintiffs' bar stands ever ready to challenge the accuracy of disclosures made by issuers. Where those issuers lack the financial resources to compensate plaintiffs and their attorneys, plaintiffs will not be reluctant to pursue the issuers' attorneys as well.

Therefore, you have two incentives to monitor your client's disclosures. First, it is clear your clients look to you to advise them in such a way as to minimize their risk of liability. This is in fact one of the primary roles of a business lawyer. That being the case, I suggest to you that in this day and age, when many are inclined to shift responsibility for their actions, 22/ you should not be surprised if failure to review zealously your clients' offering materials with an eye to complete and accurate disclosure is used by the client to support a claim of malpractice against you. Second, if that consideration is not enough, your

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22/ Remember the "Twinkie defense" used in a famous San Francisco murder trial. Nor should we forget the implications of law suits brought against tobacco companies by smokers.

own self-interest -- and the interests of your partners -- dictate that you exercise a high degree of diligence. A noted expert on professional responsibility has quoted Thurmond Arnold, founding partner of the prestigious law firm of Arnold & Porter, as saying:

> "[T]he first rule of legal ethics which you must always observe is that if you get into a difficult situation and it looks like somebody has to go to jail or pay a big judgment, you must be sure that it is the client and not the lawyer that does it." 23/

In fact, given these incentives to ensure adequate disclosure, one might well question why I need to remind you of the importance of this matter at all. The answer has several parts. First, the practice of law is a profession, but it is also a business. Successful lawyers, like successful businessmen, tend to be "can-do" people. Every once in awhile, "can-do" people need to be chided that some things cannot be done. Reminders to attorneys of their professional obligations can never come too frequently, particularly in today's atmosphere of anything goes.

Second, the critical role of the securities lawyer in protecting investors is an issue which needs to be rekindled. In the mid 1970s, considerable attention was focused on this issue, at least in part because of the Commission's enforcement action against two major law firms in connection with the National Student Marketing case. 24/ Additional interest was generated

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23/ Freeman, Liability of Counsel for Issuer, 24 Bus. Law. 635 (1969).

24/ SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978).

by the Commission's Rule 2(e) proceeding <u>In re Carter & Johnson</u>. 25/ Now, as we move away in time from those two events which so shocked the securities bar, it may be that many lawyers no longer focus on the issues raised by those cases. Without trying to define the limits of an attorney's duty, I would remind you that the rulings in both National Student Marketing and <u>In re Carter & Johnson</u> suggest that a lawyer may have an obligation to take steps beyond giving good faith advice to his client in connection with securities matters. He may be viewed as having an independent obligation to protect the process when he knows it is being abused. The idea is, I realize, an unsettling one. Frankly, the lawyer in me is not exactly enchanted with what she hears the regulator saying. Nevertheless, like it or not the precedent is there, raising significant implications in the Regulation D area. I would rather raise the issue for you now than to have you face it in the context of Commission enforcement actions or notorious private litigation.

Third, I offer these remarks today because I know that, for at least some of you, Regulation D is as close to the Commission and practice before it as you care to get. For that reason, I believe that it is an excellent opportunity to reach an audience that may not be as familiar with what the Commission expects of the securities bar as are our regular practioners. Furthermore,

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25/ Securities Exchange Act Release No. 17597, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981).

it helps to heighten the awareness of persons practicing in an unregulated area to matters of concern so that they may guard against problems developing that could result in the loss of the exemption. A case in point is the government securities area where several scandals led to proposed legislation to regulate a previously unregulated industry.

Finally, I raise this issue because I believe that deregulation of the securities markets, of which Regulation D is an important example, carries with it an increased obligation for all those in the private sector to exercise self-discipline and to undertake more responsibility for ensuring the protection of the securities markets. Thus, my remarks today echo my previous exhortations to broker-dealers and self-regulatory organizations for increased discipline and surveillance. 26/ I have found those audiences to be receptive to the message and ready to acknowledge their responsibilities and their duty to ensure that the public is protected. I am confident that you will be equally receptive and will acknowledge your responsibilities, if not with pleasure, at least with willing spirits.

Thank you.

26/ *See*, *e.g.*, Aulana L. Peters, Investor Protection: The First Line of Defense (Mar. 15, 1985)(address to Brooklyn Law School Securities Regulation Symposium).