1988

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BROKER-DEALER RESPONSIBILITY IN REGULATION D TRANSACTIONS

I. Introduction

On March 16, 1982, the Securities and Exchange Commission (SEC) adopted a set of six rules that provide issuers of small limited offering transactions exemption from the registration requirement of the Securities Act of 1933 (Securities Act). Collectively known as Regulation D, the rules are intended to clarify and simplify existing exemption rules in an attempt to expand their availability.

Much has been written regarding the duties imposed upon an issuer in a Regulation D transaction. Commentators have not, however,
addressed the degree of care a broker-dealer must exercise in a Regulation D transaction in order to insulate himself from potential liability to the purchasers. The preliminary notes preceding the rules in Regulation D make clear that issuers of a Regulation D offering are subject to the anti-fraud and civil liability provisions of the securities laws. Small Businesses Under the Securities Act of 1933, 24 WM. & MARY L. REV. 121 (1982) (same).


7. The preliminary notes preceding Regulation D state clearly that transactions under Regulation D are subject to the anti-fraud and civil liability provisions of the federal securities laws. Preliminary Notes, 17 C.F.R. §§ 230.501-230.506 (1988). Consequently, broker-dealers who are "sellers" within the statutory scheme of § 12(2) may incur liability under § 12(2). See infra notes 103-21 and accompanying text for discussion of sellers.

8. A partial explanation for the absence of commentary may be the lack of case law on this topic. Since Regulation D is relatively new, there is currently no decision involving the § 12(2) reasonable care standard in Regulation D transactions. Accordingly, this Note relies on the statutory purpose of Regulation D and past case law construing the purpose of the private offering exemptions.

9. Section 17(a) is the general anti-fraud provision of the Securities Act. See T. HAZEN, THE LAW OF SECURITIES 506 (1985 & Supp. 1987) [hereinafter HAZEN]. Section 17(a) provides in relevant part:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.


The counterpart to § 17(a) in the Exchange Act of 1934 is § 10(b), which provides in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


Rule 10b-5, promulgated by the SEC under the authority granted in § 10(b), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . .


Although a private right of action exists under § 10(b) and Rule 10b-5, see Herman & MacLean v. Huddleston, 459 U.S. 375, 387 (1983) (the aggrieved purchaser must prove scienter on the part of the defendant to sustain a cause of action). Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, reh'g denied, 425 U.S. 986 (1976). Consequently, unless the plaintiff can prove scienter on the part of the defendant, the plaintiffs are left to the remedies made available in §§ 11 and 12. Note, "Reasonable Care" in Section 12(2) of the Securities Act of 1933, 48 U. Chi. L. Rev. 372, 373 (1981) [hereinafter Reasonable Care]. Moreover, the Supreme Court in Sante Fe Indus., held that § 10(b) requires proof of "manipulation" or "deception" and not a "mere" breach of fiduciary duty. Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977).

10. Under the Securities Act, an issuer of securities may incur civil liability under §§ 11 and 12. Securities Act of 1933, §§ 11, 12, 15 U.S.C. §§ 77k-77l (1982). Under § 11 an issuer will incur liability when the registration statement contains "an untrue statement of a material fact or a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a) (1982). Liability is based on the registration statement and therefore § 11 is not applicable to exempt offerings due to the lack of a registration. Securities Act of
ties laws.\textsuperscript{11} In light of the Supreme Court’s decision in \textit{Ernst & Ernst v. Hochfelder},\textsuperscript{12} which limits suits under section 10(b),\textsuperscript{13} and Rule 10b-5\textsuperscript{14} actions to those plaintiffs who can prove scienter,\textsuperscript{15} an aggrieved purchaser who cannot prove scienter may seek relief under section 11\textsuperscript{16} and section 12(2)\textsuperscript{17} of the Securities Act. Because section 11 applies only to registered securities, and while section 12(2) applies


Section 12(1) provides civil liability for seller’s failure to register securities as required under § 5 of the 1933 Act. Securities Act of 1933, § 12, 15 U.S.C. § 77l(1) (1982). For a definition of “seller” within the § 12(1) context, see Pinter v. Dahl, 56 U.S.L.W. 4579, 4584-88 (U.S. June 15, 1988). In \textit{Lewis v. Walston & Co.}, the Fifth Circuit imposed liability on a broker for the unauthorized sales of unregistered securities by the broker’s registered representatives. 487 F.2d 617, 621 (5th Cir. 1973). This Note will not discuss liability under § 12(1) because it assumes that a broker-dealer involved in a Regulation D offering makes certain that the issuer has complied with the requirements set forth in Rules 501 to 503. See infra notes 42-55 and accompanying text for the conditions to be followed.

Liability under § 12(1) is one of strict liability; therefore, the intent and knowledge of the seller is irrelevant. See Loss, \textit{supra} note 4, at 883; M. Steinberg, \textit{Securities Regulation} 390 (1986) [hereinafter \textit{Steinberg}]. According to Professor Loss, the plaintiff need only prove: (1) that the defendant was the seller; (2) that some means of interstate commerce was used to facilitate the sale; (3) that the defendant failed to comply with the registration requirements; (4) that the suit was brought within the statute of limitations and; (5) that adequate tender was made when the plaintiff is seeking rescission. Loss, \textit{supra} note 4, at 883. The seller’s only defense is that the security in question is exempt from the requirements of § 5. See Loss, \textit{supra} note 4, at 883. Section 12(2) of the Securities Act is the primary source of liability for the broker-dealer in light of \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. at 196, which had the effect of remitting aggrieved purchasers who cannot prove scienter to the remedies available in § 12(2). Section 12(2) provides in relevant part:

\begin{quote}
Any person who—
\begin{enumerate}
\item offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him . . . .
\end{enumerate}
\end{quote}


12. 425 U.S. 185. The Court held, \textit{inter alia}, that the language of the statute and its legislative history clearly imply that scienter is required on the part of the defendant for liability under § 10(b) and Rule 10b-5. \textit{Id.} at 197-206.


liability to unregistered securities, an aggrieved purchaser of Regulation D securities is remitted to the explicit remedies for negligent non-disclosure under section 12(2).\textsuperscript{18}

This Note examines the responsibilities a broker-dealer has under section 12(2) in Regulation D transactions. Part II outlines the general framework of Regulation D. Part III examines the section 12(2) liability for Regulation D sellers, and Part IV determines responsibilities a broker-dealer has with respect to Regulation D transactions. The Note concludes that because the private placement market\textsuperscript{19} generally consists of those persons who are sophisticated and knowledgeable in financial matters, these investors do not need the full protection of the Securities Act's registration requirements. Consequently, broker-dealers involved in Regulation D transactions should not be required to exercise "due diligence."\textsuperscript{20}

\section{II. Framework of Regulation D}

The SEC, under the authority granted by section 19(a)\textsuperscript{21} and pursuant to section 3(b)\textsuperscript{22} and with respect to section 4(2)\textsuperscript{23} of the 1933 Act, promulgated Regulation D to relieve the small offering issuer from

\textsuperscript{18} See H. Bloomenthal, Securities Law Handbook 278 (1987) [hereinafter Bloomenthal]. The chief function of § 12(2) is to reinforce § 11 so that the securities laws may reach those who sell securities that are unregistered and consequently outside the scope of § 11. \textit{Id}. at 278.

Section 12(1) liability is not discussed in this Note. Section 12(1) provides liabilities for those issuers who sell unregistered securities as required under § 5 of the Securities Act. For cases discussing 12(1) liability, see Pinter v. Dahl, 56 U.S.L.W. 4579 (U.S., June 15, 1988); Abell v. Potomac Ins. Co., 858 F.2d 1104 (7th Cir. 1988); Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980); Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); Crooker v. SEC, 161 F.2d 944 (1st Cir. 1947); Schillner v. Vaughan Clark & Co., 134 F.2d 875 (2d Cir. 1943).

\textsuperscript{19} See N. Prifti, supra note 4, at 1-31. Prifti claims that there are three types of private markets: (1) an initial private purchasers (noninstitutional) market; (2) an initial private purchasers (institutional) market; and (3) a resale by private purchasers to other private purchasers market. \textit{Id}. Regulation D offerings involve only type 1 and 2 market types because resales of Regulation D securities are prohibited under Rule 502.

\textsuperscript{20} Section 11 of the Securities Act provides a "due diligence" defense against liability if the defendant can show "after reasonable investigation [he had] reasonable ground[s] to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission \ldots". Securities Act of 1933, § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (1982).


\textsuperscript{22} Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (1982). Section 3(b) provides in relevant part:

\begin{quote}
The Commission may from time to time by its rules and regulations, \ldots add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title \ldots with respect to such securities is not
\end{quote}
the demanding and expensive burden of registration under the 1933 Act. Congress provided this exemption for small offerings with a limited number of participants. The rationale behind the small offering exemption is that the public benefits of registration are too remote to justify the imposition of the expensive and time consuming registration process upon issuers of small offerings. Consequently, section 3(b) permits the SEC to promulgate rules and regulations to exempt issuers from registration if "it finds . . . registration] is not necessary [for] the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering . . . ." Section 4(2) of the Securities Act provides an exemption from registration if the issuer is "not involv[ed] in any public

necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering . . . .

Id.


24. Registration of securities in preparation for a public offering can cost more than $100,000. HAZEN, supra note 9, at 8.

25. The registration process is designed with the intent that appropriate information be filed with the SEC to ensure that members of the investing public have adequate information on which to base their investment decisions. See Loss, supra note 4, at 89; see also HAZEN, supra note 9, at 31. Accordingly, the registration statement is the basic disclosure document that must be filed with the SEC for compliance with the 1933 Act's registration requirement. See Securities Act of 1933, § 5, 15 U.S.C. § 77e (1982). There are many forms for registration depending on the nature of the issuer and/or the circumstances surrounding the offering as well as the types of the securities that are offered. See LOSS, supra note 4, at 147. As a general rule, there are two parts to the registration statement. The first part contains the prospectus which includes material information such as the issuer's name, the state of the issuer's incorporation, and the location of the principal place of business. Part two contains additional information that is not distributed in the prospectus but which is made available, through a registration filing with the SEC, for public inspection. See HAZEN, supra note 9, at 31-50. For conditions required in a complete registration statement, see Regulation C, 17 C.F.R. §§ 230.400-230.494 (1988).

26. Small offerings for purposes of this Note are those offers made pursuant to § 3(b) and § 4(2) of the Securities Act. It should be noted, however, that § 4(2) is not a small offering in terms of amount restriction. Section 4(2) is discussed in this Note due to Rule 506 and its implication with respect to Regulation D. See Securities Act of 1933, §§ 3(b), 4(2), 15 U.S.C. §§ 77c(b), 77d(2) (1982).

27. Regulation D contains three types of offering exemptions that are differentiated by the dollar amount of the offering. 17 C.F.R. §§ 230.504-230.506 (1987). In addition, issuers are limited as to the number of purchasers dependent on the type of issues. Id.

28. There are various disadvantages of going public in connection with the sale of securities, such as the expense of registration and the additional regulation, and market pressure to perform. See H. BLOOMENTHAL, 1986 GOING PUBLIC HANDBOOK 3-1 to 3-2 (1986) [hereinafter HANDBOOK].

29. See supra note 24.

lic offering." Since an issuer of an exempt offering is relieved of the burdens of registration, it is the burden of the issuer to prove the availability of the exemption.

A. Preliminary Notes to Regulation D

Regulation D is introduced by seven preliminary notes. The preliminary notes begin by explaining that Regulation D issuers remain subject to the anti-fraud provisions and certain civil liability sections of the federal securities law. They also make clear that issuers are obligated to update information as necessary to ensure that information already furnished is not misleading, and stress that compliance with Regulation D does not exempt issuers from compliance with applicable state securities laws. The notes also provide that the exemptions available under Regulation D are not the exclusive means of obtaining exemptions from registration under the 1933 Act, and that attempted compliance with Regulation D does not act as an election of such exemptions. For example, if an issuer fails to meet the condition for Rule 506, he may nonetheless qualify for exempt offering


32. See Lively v. Hirschfels, 440 F.2d 631, 632 (10th Cir. 1971) (issuer is required to prove availability of private exemption); Parker v. Broom, 820 F.2d 966, 968 (8th Cir. 1987) (the burden of proving a private offering rests upon the issuer); see also Loss, supra note 4, at 274-75.


35. See id. Although specific disclosure is not required, public information must be updated to guard against misstatements. See Preliminary Notes, 17 C.F.R. §§ 230.501-230.506 (1988).


37. See Preliminary Note 2, 17 C.F.R. §§ 230.501-230.506 (1987). Regulation D is meant to be uniform with state securities laws. See Regulation D—Revision of Certain Exemptions from Registration Under the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83106, at 84,907 (Mar. 8, 1982). The SEC related that one of the objectives of Regulation D is to "develop a basic framework of limited offering exemptions that can apply uniformly at the federal and state levels." Id. at 84,909. For example, if there is an offering under Rule 504 that complies with the blue sky law of the state in which the security is offered, the restriction on resale and the manner of offering will not apply. Id. at 84,909; see also California Casualty Management Company, SEC No-Action Letter, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,940, 79,532 (Apr. 17, 1985).

under section 4(2).\(^{39}\)

Since Regulation D is intended to apply only to transactions, securities purchased through a Regulation D offering may not be resold unless they are accompanied by a registration statement or fall independently within an exemption.\(^{40}\) The notes confirm that Regulation D is available for issues during business combinations.\(^{41}\) Regulation D is not available, however, when it is part of a plan or scheme to evade the registration requirements of the 1933 Act.\(^{42}\) Finally, note 7 explains that sales to foreign persons made outside of the United States need not comply with the registration requirements of the 1933 Act.\(^{43}\)

B. Rules 501 to 506

Regulation D may be divided into two parts. Rules 501 to 503 set forth the general terms and conditions to be complied with when offering issues under Regulation D.\(^{44}\) Rules 504 to 506 set forth the specific exemptions available under Regulation D.\(^{45}\)


Rule 501 provides definitions for terms used throughout Regulation D.\(^{46}\) One very important term is “accredited investor.”\(^{47}\) The concept of an accredited investor supplements that of a sophisticated pur-

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39. See ELKINS & MEeks, supra note 38.
41. See Preliminary Note 5, 17 C.F.R. §§ 230.501-230.506 (1988). "Business Combination" means those transactions "specified in paragraph (a) of Rule 145 under the Securities Act and any transaction involving the acquisition by one issuer, in exchange for all or a part of its own or its parent's stock, or stock of another issuer, if immediately after the acquisition, the acquiring issuer has control of the other issuer . . . ." ELKINS & MEeks, supra note 38, at A-26.
46. Rule 501 provides definitions of: accredited investor, 17 C.F.R. § 230.501(a) (1988); affiliate, id. § 230.501(b); aggregate offering price, id. § 230.501(c); business combination, id. § 230.501(d); calculation of number of purchasers, id. § 230.501(e); executive officer, id. § 230.501(f); issuer, id. § 230.501(g); and purchaser representative, id. § 230.501(h). The SEC has proposed that plans established and maintained by state governments and their political subdivisions, including their agencies and instrumentalities, for the benefit of their employees, be included in the definition of "accredited investor." See Notice of Proposed Rulemaking, Regulation D Revision to Accredited Investor Definition, 54 Fed. Reg. 308 (1989).
47. Under Regulation D, if the issuer is dealing only with accredited investors, the Rules do not require that he provide specific information for any amount of sale. 17
chaser concept by using the financial status of the potential investor to determine whether the purchaser is sophisticated and knowledgeable in financial matters. The existence of non-accredited purchasers determines the scope of information to be provided by the issuer, for the issuer will be obliged to provide specific information only in the event that he sells to non-accredited purchasers. In addition, the number of purchasers under a Rule 505 and 506 offering is limited to thirty-five.

Rule 502 sets forth four conditions applicable to all offers and sales

C.F.R. § 230.502(b)(1)(i) (1988). Rule 501(a) provides in relevant part that an accredited investor is:

(1) any bank; . . . any insurance company; . . . investment company; . . . small business investment company; . . . employer benefit plan; . . . any broker or dealer registered pursuant to § 15 of the Securities Exchange Act of 1934 . . . ;
(2) any private business development company . . . ;
(3) any organization . . . not formed for the specific purpose of acquiring the securities offered with total asset in excess of $5,000,000 . . . ;
(4) any director, executive officer, or general partner of the issuer . . . or any director, executive officer, or general partner of a general partner of that issuer;
(5) any natural person whose individual net worth . . . exceeds $1,000,000 . . . ;
(6) any natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year;
(7) Any trust with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person . . . ;
(8) Any entity in which all of the equity owners are accredited investors under paragraphs (a)(1),(2),(3),(4),(6), or (7) of this section.


Anyone not fitting into one of the above categories is considered a non accredited purchaser. The term accredited investor becomes important when a broker dealer has to determine what degree of reasonable care is due to the purchase and the transaction. See infra notes 119-65 and accompanying text. The SEC has now included "those governmental employee benefits plans that have total assets in excess of $5 million" within the definition of accredited investor. Regulation D, Accredited Investor and Filing Requirements, 54 Fed. Reg. 11369 (1989) (to be codified at 17 C.F.R. 230.507-230.508).

48. A "sophisticated purchaser is one who is knowledged and experienced in financial and business matters that demonstrate the ability to evaluate a prospective investment." Seldin, Who Cares About the Accredited Investor?, 15 REV. OF SEC. REG. 810 (1982).

49. Those who are sophisticated in financial matters are able to fend for themselves without the benefits of disclosure. SEC v. Ralston Purina, 346 U.S. 119, 125 (1953); See also Parker v. Broom, 820 F.2d 966 (8th Cir. 1987). But see Quincy Coop. Bank v. H.G. Edwards & Sons, Inc., 655 F. Supp. 78 (D. Mass. 1986) (a sophisticated investor is entitled to the same full protection and disclosure requirements as a naive investor).

50. If all of the issuer's purchasers are accredited, Regulation D does not require that specific information be provided to the purchasers. 17 C.F.R. § 230.502(b)(1)(ii) (1988).

51. Both Rule 505(b)(2)(ii) and Rule 506(b)(2)(i) require that the issuer reasonably believe that there are no more than 35 purchasers of securities from the issuer. 17 C.F.R., §§ 230.505(b)(2)(ii), § 230.506(b)(2)(i) (1988). The term "purchasers" in this instance does not include "accredited investors." Id. § 230.501(c).
made under Regulation D.\textsuperscript{52} The first condition to be met is the condition against integration.\textsuperscript{53} Integration is to be avoided so that the issuer will not exceed the maximum amount allowed under rules 504-506. To avoid integration, a Regulation D offering may be offered six months before or after other offers and sales.\textsuperscript{54} Further, such other offers and sales must not have been similar to those in Regulation D.\textsuperscript{55} The second condition consists of the requisite types of information and their methods of presentation to purchasers.\textsuperscript{56} If the issuer is selling only securities under section 230.504 or is selling only to accredited investors, Rule 502 does not require that specific information be provided to the purchasers. However, if the sale of securities is under Rule 505 or 506 and any of the purchasers is not an accredited investor, information as specified in Rule 502(2) must be provided.\textsuperscript{57} The third condition is the prohibition on general solicitation and publication.\textsuperscript{58} Unless the issuer is selling securities under Rule 504 and is selling exclusively in states that require registration and disclosure, Rule 502(c) prohibits any use of general solicitation or general advertising.\textsuperscript{59} Furthermore, Rule 502(d) also prohibits resale.\textsuperscript{60} Securities acquired in accordance with Regulation D offerings have the same unregistered status as securities acquired under section 4(2) of the 1933 Act and thus may not be resold without registration.\textsuperscript{61}

In addition to these three conditions, Rule 502 expressly states that the issuer is under a duty to exercise reasonable care to make certain that purchasers are not underwriters.\textsuperscript{62} An underwriter as used in this provision means a "person that has been paid or will be paid remuneration for solicitation of purchasers . . . ."\textsuperscript{63} The duty to make certain that the purchasers are not underwriters includes a reasonable

\textsuperscript{52} 17 C.F.R. § 230.502 (1988).
\textsuperscript{54} Id.
\textsuperscript{55} Id.
\textsuperscript{56} 17 C.F.R. § 230.502(b) (1988). For a synopsis of information to be provided, see Steinberg, supra note 10, at 122-23.
\textsuperscript{57} Id.
\textsuperscript{59} Printing Enterprise, supra note 58, ¶ 77,415, at 78,513.
\textsuperscript{60} 17 C.F.R. § 230.502(d) (1988).
\textsuperscript{61} Id.; cf. Lively v. Hirscheifds, 440 F.2d 631, 632 (10th Cir. 1971) (discussing private offering under § 4(2)).
\textsuperscript{62} 17 C.F.R. § 230.502(d) (1987).
inquiry as to whether the purchaser is acquiring the security for himself or another, and the provision of written disclosure of the limitation on resale and placement of a legend on the securities certificate indicating their unregistered status. Rule 503 provides requirements for filing notice of sale with the SEC in compliance with Form D, and provides a notice of sale by requiring the issuer to file Form D. Rule 503 provides further that a seller of Rule 505 securities must provide to the SEC all information furnished to non-accredited purchasers upon a request by the Commission.

2. Rules 504 to 506: Specific Exemptions

The second set of Rules under Regulation D provides the specific exemptions available based on the size of the offering. The three exemptions are distinguished principally by the maximum dollar amount of the offering permitted under each exemption.

a. Rule 504 Exemption for Small Issues of $1,000,000 or Less

Rule 504 exempts from registration offerings of up to $1,000,000 in any twelve-month period. The Rule 504 exemption is not available to investment companies and companies that are reporting compa-
nies within the meaning of the Securities Exchange Act of 1934. As a general rule, offers and sales under Rule 504 must conform to conditions set forth in Rules 501, 502, and 503, unless the offering is conducted exclusively in states that require registration and delivery of a disclosure document before the sale. There is no specific information required under Rule 504 that must be furnished to purchasers, yet a Regulation D offering is nevertheless subject to the federal anti-fraud provisions and certain civil liability provisions.

b. Rule 505 Exemption for Limited Offerings Not Exceeding $5,000,000

Rule 505 provides an exemption for limited offerings not exceeding $5,000,000 in any twelve-month period. Unlike a Rule 504 offering, a Rule 505 offering may be made to an unlimited number of accredited investors, but to only thirty-five non-accredited investors. An accredited investor is defined in Rule 501 as a person who comes within, or whom the issuer has reasonable grounds to believe comes within, any of the eight listed categories of investors. As with Rule 504 offerings, Rule 505 offerings must comply with the conditions set

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73. See 17 C.F.R. § 230.504(b)(i) (1988). If the Rule 504 offering is made exclusively in states that already require registration and disclosure statements, the limitation on solicitation and resale will not apply. Id. For example, an offering under California's Corporate Securities Law that is conditioned on offeror's delivery of a disclosure statement to the offeree would be an offering in a state that requires registration and delivery of a disclosure before the sale as is required under Rule 504. See Geraldine D. Green, SEC No-Action Letter, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,360, at 78,338 (Dec. 22, 1982); California Casualty Management Co., SEC No-Action Letter, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,940, at 79,533 (Apr. 17, 1985)
79. The categories include: institutional investor; private business development companies; tax exempt organization; directors, executive officers and general partners of the issuer; $150,000 purchasers; $1,000,000 net worth test; $200,000 income test; and entities made up of certain accredited investors. See also supra note 45.
forth in Rules 501 to 503.\textsuperscript{80}

c. \textit{Rule 506 Exemption Without Regard to Dollar Amount}

Rule 506 provides an exemption for offers and sales of securities without regard to dollar amount.\textsuperscript{81} The SEC promulgated Rule 506 from section 4(2) of the Securities Act exempting distributions of securities that do not involve any public offering.\textsuperscript{82} General solicitation or advertising is not permitted.\textsuperscript{83} Rule 506 permits the sale of securities to an unlimited number of accredited investors and to thirty-five non-accredited purchasers with the condition that the seller reasonably believe that the purchaser, or his purchase representative,\textsuperscript{84} be sophisticated and knowledgeable in financial investments.\textsuperscript{85}

III. \textit{Section 12(2) Liability}

Transactions exempt from registration are not exempt from the anti-fraud provisions\textsuperscript{86} or from the express civil liability\textsuperscript{87} sections of the federal securities laws. Issuers of Regulation D securities will be subject to the anti-fraud provisions in the 1933 Act\textsuperscript{88} and 1934 Act.\textsuperscript{89} In the absence of an allegation of fraud, the aggrieved purchaser of securities acquired pursuant to Regulation D may seek to invoke sec-

\textsuperscript{80} See 17 C.F.R. § 230.505 (1988); see also supra notes 32-40 and accompanying text.

\textsuperscript{81} See 17 C.F.R. § 230.506 (1988).

\textsuperscript{82} Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1982). While Rule 504 and Rule 505 offerings are exempt from registration because of their small amount, in addition to their nonpublic nature, a Rule 506 offering is exempt from registration solely due to its nonpublic nature. In a SEC Ruling, the SEC stated that "Rule 506 is a safe harbor rule under [§] 4(2) of the Securities Act available to any issuer . . . . There is no limit to the amount that may be raised under this exemption." SEC Ruling, Regulation D Revision, [1986-87 Transfer Binder] Fed. Sec. L. Rep. ¶ 84,054, 88,400 (Jan. 16, 1987).

\textsuperscript{83} See 17 C.F.R. § 230.502(C) (1988).


\textsuperscript{85} 17 C.F.R. § 230.506b(2)(ii) (1988). The Rule 506 exemption explicitly requires that an issuer must reasonably believe that purchasers who are not accredited purchasers have knowledge and experience in financial and business matters such that he or his purchaser representative is capable of determining the merits and risks of the investment. \textit{Id}. The SEC has also noted that all offerees and purchasers must possess the requisite level of sophistication in an offering under § 4(2). SEC Release No. 33-6455, Q & A 73, ¶ 2380 (Mar. 3, 1983). Because Rule 506 is promulgated pursuant to § 4(2), Rule 506 offerees and purchasers must also possess the requisite level of sophistication.

\textsuperscript{86} See supra notes 8-9, infra notes 119-65 and accompanying text.

\textsuperscript{87} See supra note 9.


\textsuperscript{89} Id.
tion 12(2) of the 1933 Act and its negligence standard.\textsuperscript{90} Section 12(2) affords a purchaser of a security an express right of action against the seller\textsuperscript{91} if the purchaser acquired the security by means of a prospectus\textsuperscript{92} or oral communication containing a material misstatement or omission.\textsuperscript{93} The statutory language in section 12(2) indicates that the plaintiff suing under section 12(2) need not bear the burden of establishing seller's scienter.\textsuperscript{94} Rather, the defendant must bear the burden of proving that he did not know, and in the exercise of reasonable care, could not have known of the omission or untruth of the statement.\textsuperscript{95} The Congressional committee report deemed this shift in the burden of proof "as both just and necessary, inasmuch as the knowledge of the seller as to any flaw in his selling statements, or the failure of the seller to exercise reasonable care are matters in regard to which the seller may readily testify . . . ."\textsuperscript{96}

\subsection*{A. Broker-Dealer as Seller}

The characterization of the relationship between the purchaser and the broker-dealer may be dispositive of section 12(2) liability.\textsuperscript{97} Due to the nature of the rules in Regulation D prohibiting public solicitation, an issuer has to employ broker-dealers to get access to potential investors.\textsuperscript{98} The degree of a broker-dealer's involvement in a transaction is dispositive of whether he is a seller, and therefore liable to the purchaser under section 12(2).\textsuperscript{99} A broker-dealer who does no more than act solely as the buyer's agent in executing that buyer's order,\textsuperscript{100}

\textsuperscript{90} The elements of fraud are not a part of § 12(2) liability because it is a negligence standard provision. HAZEN, supra note 9, at 203.

\textsuperscript{91} See supra notes 83-90, infra notes 91-105 and accompanying text.

\textsuperscript{92} The term prospectus means "any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." Securities Act of 1933, § 2(10), 15 U.S.C. § 77b (10) (1982). Consequently, any writing that offers a security for sale comes within the definition of prospectus in § 2(10). LOSS, supra note 4, at 106.


\textsuperscript{94} Id.

\textsuperscript{95} Id.

\textsuperscript{96} H.R. REP. No. 85, 73d Cong., 1st Sess. 9, 23-24 (1933).

\textsuperscript{97} For example a broker-dealer who neither solicited the purchase order nor recommended the securities, and acted solely as the buyer's agent cannot be deemed a seller or an offeror. Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 287 (E.D. La. 1974), aff'd, 512 F.2d 484 (5th Cir. 1975). Similarly, a broker-dealer has minimal duty, if any, to investigate the securities when he has merely received and executed a purchase order. Id.

\textsuperscript{98} See S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS 119 (1977) (discussing the accessibility of the private market by issuer of exempt securities) [hereinafter JAFFE].

\textsuperscript{99} See STEINBERG, supra note 10, at 391; see also Canizaro, 370 F. Supp. at 287 (brokers must be "sellers" to incur liability under § 12(2)).
REGULATION D TRANSACTIONS

and has neither actively solicited the order nor recommended the securities, is not deemed to be an offeror or a seller. However, those who have participated in some significant way in the sales effort, or have some relationship or connection to the seller, will incur liability as a seller.

Thus, before a broker-dealer can incur liability under section 12(2), it must be established that the broker-dealer is a seller within the meaning of section 12(2). In regard to this issue, three lines of authority have developed.

1. Strict Interpretation

In Collins v. Signetics Corp., the District Court of the Eastern District of Pennsylvania employed a strict interpretation of section 12(2) and held that the language of the statute imposes liability only on the immediate “seller” or one in privity with him. In doing so, the court concluded that the language of section 12(2) was designed for claims against immediate sellers and that any other interpretation would “frustrate the statutory schema.” The court explained that there are other sections in the 1933 Act which are specifically designed to reach nonsellers for their misconduct. Similarly, a broker was found not to be a “seller” defendant in an action under sec-

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100. Canizaro, 370 F. Supp. at 287. In instances where the broker does not actively seek the purchase order, he probably does not “sell” the securities. See Douglas & Bates, Securities Act of 1933, 43 YALE L.J. 171, 207 (1933) [hereinafter Douglas & Bates].

101. Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984). Consequently, the standard of care under § 12(2) is dictated by the circumstances of each case. Similarly, the underlying theory of exempt offerings and Regulation D would likewise impose a standard less than that required under § 11. Douglas & Bates, supra note 100, at 208 n.205.


104. 605 F.2d at 113; see also Mcfarland v. Memorex Corp., 493 F. Supp. 631, 647 (N.D. Cal. 1980) (accountants who signed the prospectus are not sellers for purposes of § 12(2) liability).


106. Collins, 605 F.2d at 113. The court distinguished between issuer and seller of security and pointed to § 11 of the Securities Act as a remedy against an issuer and not an actual seller. Id. The court in this instance did not consider the case of an unregistered security which does not come under the purview of § 11. See supra note 10 for text of § 11.
tion 12(2) because the broker did not own the stock and therefore could not have passed title.107

2. An Intermediate Approach

An intermediate approach, borrowed from tort negligence law, applies the theory of proximate causation.108 It defines "seller," for purposes of section 12(2) liability, as one who is integrally involved with or substantially involved in the offer or sale.109 In SEC v. Seaboard,110 the Ninth Circuit held that the test in determining seller status is whether the injury to the plaintiff flowed directly and proximately from the action of the defendant seller.111 In determining whether the injury flowed proximately from the actions of the defendant, the defendant's action must have been substantial in bringing about such an event.112 Closely related to this approach is the "participation theory" in which a person is a seller if his participation was a necessary element in causing the transaction to take place.113 Under this approach, the broker-dealer who had remote involvement in the transac-

109. Davis, 739 F.2d at 1067.
111. Id., ¶¶ 98,720, 98,726.
112. "Substantial factor" is that conduct which was a material and substantial factor in bringing about the transaction. See Abrams, The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent Legislation Materials, 15 FORDHAM URB. L.J. 877, 888 (1987). See Jett v. Sunderman, 840 F.2d 1487, 1491 (9th Cir. 1988); cf. SEC v. Murphy, 626 F.2d 633, 650-52 (1980) (defendant's participation in offer and sale of the securities was factor in causing the transaction to take place).
113. See Wilson v. Ruffa & Hanover, P.C., 844 F.2d 81, 86 (2d Cir. 1988). In Wilson, the Second Circuit held that a person who is a collateral participant (i.e., did not actually pass title) can incur liability if there is a showing of "loss causation and transaction causation" by the purchaser. Id. In an analogous case, Pinter v. Dahl, the Supreme Court held that one who solicits a purchaser is deemed a seller for purposes of § 12(1). Pinter v. Dahl, 56 U.S.L.W. 4579, 4586 (U.S. June 15, 1988) (No. 86-805). The Supreme Court, however, agreed with the lower court that a solicitation merely to assist the purchaser will not itself be enough to incur liability as a seller. Id. Such solicitation must be motivated by self financial interest. Id. In the lower court, the Court of Appeals for the Fifth Circuit held that the defendant had not incurred liability as seller even though he was a substantial factor in causing the transaction to take place. Id. at 4587. The court explained that imposing liability on "sellers" who gave gratuitous advice among family and friends would be disruptive of social discourse. Id; see also Royal Am. Managers, Inc. v. IRC Holding Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,091, at 91,095 (S.D.N.Y. Oct. 20, 1985).
tion would be protected, while those who were actively involved in the transaction may incur liability. 114

3. Broad Interpretation/Aiding and Abetting Analysis

The most expansive approach has extended liability to those who are co-conspirators and aiders and abettors. 115 In Lorber v. Beebe, 116 the court extended liability to the defendant, a broker, for participating in the sale as an aider and abettor or co-conspirator in connection with the fraudulent registration statement. 117 Under this approach, anyone who participates, either as a co-conspirator or as an aider and abettor in the sale of a security that was sold by means of negligent misrepresentation, may be considered a seller and, therefore, can incur liability. 118 This view has been criticized as appearing to apply a scienter standard to the section 12(2) negligence standard—an application which would be inconsistent with the statutory language. 119

An alternative to this approach suggests that liability would require privity which can be satisfied either through privity of contract or privity of misrepresentation. 120 This approach argues that privity of misrepresentation provides the necessary element between the culpable “seller,” the purchaser, and the pertinent misstatements. 121

B. Broker-Dealer Responsibility

Section 12(2) has been described as “one of the most powerful but least appreciated weapons in the arsenal of a plaintiff in a securities fraud action.” 122 Section 12(2) is the only express private remedy re-

114. SEC v. Murphy, 626 F.2d 633, 652. (9th Cir. 1980). The Ninth Circuit, in espousing the participation theory, indicated factors to be considered in determining participant liability: (1) devising the issuer’s corporate financing scheme; (2) preparing or reviewing offering memoranda; (3) meeting personally with broker-dealers or investors and; (4) participating in promotional seminars or sales meetings. Id; see also supra note 96 and accompanying text.


117. Id. at 288.

118. Id.

119. See M. Steinberg, Securities Regulation: Liability and Remedies 6-6 (1985).

120. Id. at 6-6.1 to 6-7.

121. Id. at 6-7. Still another view by the Eighth Circuit focuses on whether the defendant is uniquely positioned to ask relevant questions, receive material information or disclose his knowledge. See Wasson v. SEC, 558 F.2d 879, 886 (8th Cir. 1977).

lating to the sale of exempt securities. If the reasonable care standard of section 12(2) is construed liberally, section 12(2) can be a powerful remedy for an aggrieved purchaser, and a potential source of liability for broker-dealers. Broker-dealers involved in the sale and purchase of Regulation D securities are susceptible to section 12(2) liability even in the absence of fraud. Furthermore, potential section 12(2) liability is greatly expanded since reliance is not an element of the cause of action. Section 12(2) does, however, provide a "quasi due diligence" defense to the seller if the seller can establish that he did not know of the material misstatement or omission and, in the exercise of reasonable care, could not have known of the material misstatement or omission. Consequently, for a broker-dealer who has been found to be a seller, the outer limit of a broker-dealer's required degree of responsibility is determined by the "reasonable care" standard in section 12(2).129

1. Section 12(2)'s Reasonable Care: A Circumstantial Standard

Reasonable care under section 12(2) is the exercise of ordinary care under the circumstances. Consequently, liability will depend upon a combination of several factors. Liability will turn on the extent to

123. See Bloomenthal, supra note 18, at 278; see also Hazen, supra note 9, at 310.
124. See Steinberg, supra note 10, at 410.
125. Id.; see also supra note 9, 78.
126. See Gilbert v. Nixon, 429 F.2d 348, 356-57 (10th Cir. 1970). Plaintiff need not prove he relied on misleading statements or material omission(s) in a § 12(2) action. Id. It has been recognized that once the plaintiff is successful in proving a material omission, reliance will be presumed. See Austin v. Loftsgaarden, 675 F.2d 168, 177 (8th Cir. 1982) (reliance is presumed when a material omission is proved); Sanders v. John Nuveen & Co., 619 F.2d 1222, 1226 (7th Cir. 1980) (plaintiff need not show he ever received the misleading prospectus), cert. denied, 450 U.S. 1005 (1982). Plaintiff does, however, need to show some causal connection between the challenged communication and the sale even if not decisive. See Austin, 675 F.2d at 179; Jackson v. Oppenheim, 533 F.2d 826, 830 n.8 (2d Cir. 1976).
128. Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1982). Section 12 provides that a seller may escape liability if he can sustain the "burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . ." Id. (emphasis added).
130. See Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984) (defendant may escape liability by showing an exercise of ordinary care). In tort law, the conduct of a reasonable person is said to vary with the situation. See W. P. Keeton & W. L. Prosser, Prosser and Keeton on Torts 175 (1984).

In Davis, the Sixth Circuit considered the following factors to determine whether a person [broker-dealer] has exercised due care:

(1) The quantum of decisional (planning) and facilitative (promotional) partici-
which the broker-dealer was involved in the preparation of the transaction;\textsuperscript{131} the nature of the selling effort by the broker-dealer in soliciting the purchase order;\textsuperscript{132} the degree of sophistication of the buyer;\textsuperscript{133} the prior relationship between the broker-dealer and the issuer; and the extent to which reliance is placed upon the broker's recommendation.\textsuperscript{134}

\textsuperscript{131} Unlike an underwriter who is intimately involved in the preparation of the prospectus, see generally \textit{HANDBOOK}, supra note 28, §§ 3.01-3.04, 6.13, the broker-dealer will not normally be intimately involved in the preparation of the prospectus, because there is generally a lack of any disclosure statement. \textit{Seldin, Who Cares About Accredited Investor?}, 15 REV. OF SEC. REG. 810 (1982). Even the court in \textit{Sanders v. Nuveen & Co.} suggested that the special relationship between an underwriter and an issuer is such that it will require an investigation. 619 F.2d 1222, 1228 (7th Cir. 1980), \textit{cert. denied}, 450 U.S. 1005 (1982). It left open, however, the question of what reasonable care would be if the defendant had not been an underwriter. \textit{Id.} Consequently, absent some special relationship, the broker-dealer should not incur liability under § 12(2). \textit{Canizaro v. Kohlmeyer & Co.}, 370 F. Supp. 282, 287 (E.D. La. 1974), \textit{aff'd per curiam}, 512 F.2d 484 (5th Cir. 1975).

\textsuperscript{132} At one extreme are situations where a salesman or representative of the broker-dealer actively solicits purchase orders through aggressive telephone solicitation—a practice known as "boiler room" operations. The duty of care placed on the seller is greater than what would be required as reasonable care. \textit{HAZEN, supra} note 9, at 278-79. Broker-dealers should not encounter this situation under Regulation D because general solicitation is prohibited, 17 C.F.R. § 230.502(c) (1988), and Regulation D provides a purchaser with a "reasonable time prior to his purchase of securities... to ask questions and receive answers concerning the terms and conditions of the offering..." 17 C.F.R. § 230.502(b)(v) (1988). On the other hand, if the broker-dealer acted solely as executor in carrying out the transaction, he does not owe any duty to investigate the securities in question. \textit{Canizaro}, 370 F. Supp. at 287. Similarly, if the broker acts as principal, he acts for no one and owes no duty to the purchaser. See \textit{S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES} 1-11 (1978).

\textsuperscript{133} Private offering purchasers are deemed to be sophisticated and able to "fend for themselves." \textit{SEC v. Ralston Purina}, 346 U.S. 119, 125 (1953). The SEC has stated that those purchasers under Rule 506 must have the requisite level of sophistication. SEC Release No. 33-6455, Fed. Sec. L. Rep. ¶¶ 2380, 2637-11, -12 n.42 (1983). Since this prerequisite applies to both accredited and non-accredited purchasers, it may then be construed to mean that all purchasers under Regulation D must be sophisticated. If the plaintiff is financially sophisticated, and has prior experience in engaging in speculative investments, the burden on the seller to disclose information is less demanding. Phillips \textit{v. Reynolds & Co.}, 294 F. Supp. 1249, 1255-56 (E.D. Pa. 1969) (broker is liable under Rule 10b-5 for failure to disclose information due in part to sophistication of purchaser).

Because a broker-dealer may incur liability under section 12(2) for material misstatements or omissions about the issuer and is held to the reasonable care standard, the broker-dealer is under a duty to investigate the securities. His recommendation to purchase the securities implies that he made a reasonable investigation. It is further implied that his recommendation rests on conclusions drawn from his investigation. The broker-dealer's duty to his customer, the purchaser, is to investigate and disclose all material facts and that duty will increase in direct proportion to the degree of his participation in the sale.

2. Sanders: Due Diligence

In Sanders v. John Nuveen & Co., Nuveen, an exclusive underwriter of commercial paper, was held liable for using a materially misleading prospectus, even though in preparing the prospectus, the underwriter had relied on certified financial statements prepared by an independent accounting firm. The Seventh Circuit interpreted the reasonable care standard of section 12(2) as requiring a reasonable investigation by the underwriter of the securities. Consequently, the court applied the due diligence standard of section 11 and held

135. See supra note 116, infra notes 146-65 and accompanying text.
136. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) (broker-dealer's recommendation implies that reasonable investigation has been made).
137. Id.
138. Rule 12b-2 defines materiality as:

The term “material,” when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

140. 619 F.2d 1222 (7th Cir. 1980), cert. denied, 450 U.S. 1005 (1981).
141. Id. at 1227.
142. Id. at 1228.
143. Id. at 1227-28.
144. Id. at 1228. Section 11(b) of the Securities Act provides a due diligence defense. See Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (discussing due diligence). Section 11(b) provides in relevant part:

[N]o person, other than the issuer, shall be liable [and] . . . who shall sustain the burden of proof that:

(A) as regards any part of the registration statement not purporting to be made
that because the defendant failed to investigate the certified financial statements, he had failed to exercise reasonable care.\(^{145}\)

In essence, the *Sanders* court equated the reasonable care standard in section 12(2) with the reasonable investigation standard in section 11.\(^{146}\) In doing so, the court found no significance in the difference in language between "reasonable investigation" found in section 11 and "reasonable care" found in section 12(2) of the Securities Act.\(^{147}\)

Moreover, the court held that an underwriter, because of his position, has much greater opportunity to obtain information.\(^{148}\) Consequently, the broker-dealer's responsibility is not comparable to that of the underwriter.\(^{149}\) Rather, it appears that a broker-dealer's responsibility will turn on the facts and circumstances of each case.\(^{150}\) The Supreme Court denied certiorari,\(^{151}\) with Justice Powell writing a vigorous dissent in which Justice Rehnquist joined.\(^{152}\)

Justice Powell argued that the Seventh Circuit had misinterpreted section 12(2) as requiring reasonable investigation.\(^{153}\) He feared that the decision would be read by courts and broker-dealers as requiring an independent financial investigation rather than permitting reliance on the financial statements provided by an issuer.\(^{154}\) Accordingly, Justice Powell would allow a broker-dealer to rely on a certified financial statement of the issuer.\(^{155}\) To require further investigation would

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on the authority of an expert... he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading;... and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself)... he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading... .


146. Id. at 1228.
147. Id.
148. Id.
149. Id.
150. Id.
152. Id. (Powell, J., dissenting).
153. *Id.* at 1009-10 (Powell, J. dissenting).
154. Id. at 1011 (Powell, J. dissenting). This would impose a greater burden than what is already required under § 11's due diligence standard. Section 11 allows a defendant to rely on the expert opinion of others. Id. at 1010 (Powell, J. dissenting). See supra notes 20, 143.
place a greater burden on the broker-dealer than is required by the statutory scheme. 156

IV. Recommendations as to Liability of a Broker-Dealer in Regulation D Transactions

A broker-dealer's liability under section 12(2) with respect to Regulation D securities should depend on several factors: (1) the role of the broker-dealer in preparation of the transaction; 157 (2) the prior relationship between the purchaser and broker-dealer; 158 (3) the nature of the selling effort; 159 (4) the sophistication of the purchaser; 160 and (5) the availability of public information. 161

Regulation D was promulgated in recognition of the fact that small issues, because of their size, 162 and the nature of the purchaser, 163 do not warrant the protection of the registration requirement. 164 Likewise, the requirement of a reasonable investigation should not be imposed. 165 Rather, liability should turn on the circumstances of the

156. Id. (Powell, J. dissenting).
157. Cf. Sanders, 619 F.2d at 1228. The Seventh Circuit explained that an underwriter is held to a higher standard of duty because of his intimate relationship with the registration statement. Accordingly, a broker-dealer who is an "underwriter" for purposes of the offering and who, therefore, has a strong connection with the preparation of the prospectus, should be held to a higher degree of care. Id.
158. A broker is charged with the duty of knowing the suitability of the stock for his customer. Clark v. John Lamula Inc., 583 F.2d 594, 600 (2d Cir. 1978). Under the "know your customer rule" the broker is required to consider the financial condition and circumstances of the customer. JAFFE, supra note 98, at 250. Since Regulation D requires that purchasers be sophisticated, SEC Release No. 33-6455, FED. SEC. L. REP. & A 73, ¶ 2380 (Feb. 5, 1986), and be accredited in the case of Rule 505 and Rule 506 offerings, 17 C.F.R. §§ 230.505-230.506 (1987), it follows that a broker-dealer must know the financial status of the purchaser. In addition, Rule 506 expressly requires that the offeror have a reasonable belief that the purchaser is capable of evaluating the securities based on financial knowledge and experience. 17 C.F.R. § 230.506(b)(1)(ii) (1987). If the broker-dealer was involved in the transaction as an agent for the customer, it would be unlikely that he would incur liability. Douglas & Bates, supra note 100, at 207. Further, if the broker-dealer increases his involvement, such as by solicitation, then his probability of incurring liability will increase. Id.
159. See supra notes 120-21 and accompanying text.
160. See infra note 161.
161. See supra notes 120-21 and accompanying text.
162. In the case of Regulation D, the maximum amount under Rule 504 is $500,000. 17 C.F.R. § 230.504 (1987). Under Rule 505, the maximum amount is $5,000,000. 17 C.F.R. § 230.505 (1987). Under Rule 506, the offering has no maximum amount limitation. It does, however, impose a purchaser restriction by requiring offeree sophistication and limiting sales to 35 non-accredited purchasers. See 17 C.F.R. § 230.506 (1987).
163. See supra notes 42-73 and accompanying text.
164. See supra notes 24-25.
165. Reasonable investigation in this context is required under § 11 to escape liability. Rule 176 provides guidelines as to what constitutes reasonable investigation under section
selling effort and the broker-dealer's participation in the preparation of the transaction. Further, protection of a full registration statement is not warranted because Regulation D generally requires that purchasers be sophisticated.

The absence of a disclosure requirement in Regulation D is also indicative of the SEC's faith in the financial sophistication of the purchasers of Regulation D offerings. Issues under Rule 504 require no disclosure. In addition, Rules 505 and 506 only require specific information to be furnished in the event of purchases by non-accredited investors. Rules 505 and 506 also require that an issuer make available to each purchaser an opportunity to ask questions and receive answers concerning the offerings. They also provide, however, that any information sought from the issuer need not involve unreasonable effort or expense. The lack of any specific disclosure requirement suggests that because of the financial status of Regulation D purchasers and the sophistication inferred from that status, purchasers do not need the protection of the registration.

The absence of a required disclosure statement alleviates the burden...

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11(c) of the Securities Act. 17 C.F.R. § 230.176 (1987). Among the factors to be considered are: "(a) [t]he type of issue ... (b) [t]he type of security ... (c) [t]he type of person ...," 17 C.F.R. § 230.176 (1988).

Under Regulation D, when the offering (with the exception of Rule 506) is less than $5,000,000, no investigation is required under the Rules. It may, however, be prudent to ascertain the financial suitability of the purchaser. See supra note 158. When the offer is governed by Rule 506 (presumably over $5,000,000), the offeror has a duty to ascertain the financial sophistication of the purchaser. 17 C.F.R. § 506(b)(2)(ii) (1987). Accordingly, since the purchasers are deemed to be sophisticated and financially stable, the broker-dealer need not go through the expense of a "due diligence" investigation as required in Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (underwriter has duty to make reasonable investigation under § 11 of the Securities Act).

166. See supra notes 119, 132.
167. See supra note 162.
170. See id.
172. Id.
173. In a brief filed by the SEC in Sanders v. John Nuveen & Co., the SEC stated that:
Since Congress has determined that registration is not necessary in certain defined situations [exempt offerings], we believe that it would undermine the congressional intent—that issuers and other persons should be relieved of registration—if the same degree of investigation were to be required to avoid potential liability whether or not a registration is required.

on broker-dealers to investigate issuers, and justifiably so, because it is already recognized that private offerings are available only to purchasers who are able to fend for themselves.\textsuperscript{174} It should be recognized, however, that in instances where the Regulation D exemptions are utilized by small companies to gain start-up capital, a more thorough investigation into the stability of the company should be required.\textsuperscript{175}

A reasonable investigation will also be required in certain instances as an exercise of reasonable care.\textsuperscript{176} This exercise of reasonable care, however, should not require investigation beyond a professionally certified statement or report.\textsuperscript{177}

V. Conclusion

A pragmatic approach to section 12(2) is to construe "reasonable care" in light of the circumstances of each case. In the case of Regulation D transactions, the reasonable care standard is less exacting than the due diligence or reasonable investigation standard.\textsuperscript{178} It would be contrary to the statutory language to impose a duty of reasonable investigation when the statute explicitly provides for a reasonable care standard.\textsuperscript{179} Because Regulation D offerings are made to those who are sophisticated and knowledgeable in financial matters, it would subvert the purpose of Regulation D to place upon broker-dealers the same duty of care as if they were involved in registered transactions. Moreover, broker-dealers involved in Regulation D offerings do not have the same intimate involvement as an underwriter

\textsuperscript{174} See SEC v. Ralston Purina, 346 U.S. 119 (1953) (private offering is available only to those who are able to fend for themselves); see also Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971) (requiring that offerees have exceptional business background or equivalent level of sophistication).

\textsuperscript{175} Because Regulation D is intended to be used by small companies to gain capital without the burden of registration, or by companies of recent origin to acquire start-up capital, a thorough investigation may be in order when the securities are speculative. See Hanly v. SEC, 415 F.2d 589, 598-99 (2d Cir. 1969). The SEC has also recommended that when the securities are offered in connection with high risk or speculative ventures, a diligent investigation may be required. See SEC Release Nos. 33-5275, 34-96712, Fed. Sec. L. Rep. ¶ 4506b, 4052 (July 26, 1972).


\textsuperscript{177} Section 11 of the Securities Act, which imposes a reasonable investigation duty, provides that potential defendants may rely on "any part of the registration statement purporting to be made on authority of expert . . . ." Securities Act of 1933, § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C) (1982).

\textsuperscript{178} Douglas & Bates, supra note 100, at 208 n.205.

\textsuperscript{179} The courts should look first to the language of the statute. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). See also Reasonable Care, supra note 9, at 379-87; Douglas & Bates, supra note 100, at 171-73.
has in a public offering. Such broker-dealers should not, therefore, have the burden of a due diligence investigation.

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