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Comment: The Significance of Non-Publicness for Securities Interventions

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COMMENT: THE SIGNIFICANCE OF NON-PUBLICNESS FOR SECURITIES INTERVENTIONS

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What I say here can be labeled something like *The Significance of Non-Publicness for Securities Interventions*, and, at any point, the term "privateness" may be substituted for non-publicness. My comments cut across both present and proposed intervention systems. The notion of non-publicness (or its equivalent, privateness) surfaces time and time again throughout the regimes of securities interventions—the Securities Act of 1933,[1] the Securities Exchange Act of 1934,[2] and other federal and state legislation. Legislatures, courts, and administrative agencies presently achieve various effects in recognition of the non-publicness of transactors, but we must keep our eye on those effects, so as to test the relevance of non-publicness to each of them.

At stake are two different but basic types of intervention. First, there is what might be called "itemized disclosure" or "mandatory disclosure." I refer to it as itemized disclosure in these comments and contrast it with "anti-deception" interventions. With respect to each of these, there is a separate question of whether to provide public enforcement (civil or criminal, but nonetheless public) or private civil enforcement, or both. I will run through some examples of the occasions upon which we recognize non-publicness in present law.

Under the 1933 Act, issuer-originated transactions are dispensed from the itemized disclosure process because of the non-publicness of transactors. This carve-out operates mainly through section 4(2),[3] either under judicial and administrative interpretations or through rule 506.[4] The same effect is achieved with respect to control-person non-issuer-originated transactions, because the courts and agencies have

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1 15 U.S.C. §§ 77a-77bbbb (1994).

2 *Id.* §§ 78a-78kk.

3 *Id.* § 77d(2).

4 17 C.F.R. § 203.506 (2000).

read the requirement of publicness, the opposite of non-publicness, into the meaning of the word "distribution" in section 2(a)(11),[5] and—to make a long story short—this permits non-issuer transactions with private offerees to receive a section 4(1) exemption.[6] So non-publicness creeps into the non-issuer transactional scheme as a basis for dispensing with itemized disclosure. Anti-deception coverage, however, is left undisturbed by the mechanisms just described.

Transactions between issuers and underwriters are definitionally excluded under section 2(a)(3),[7] with respect to itemized disclosure and possibly (there is some reason for debate) even with respect to the anti-deception provisions.

The Supreme Court, in accomplishing what some long thought Congress had not, has held that, at least in offerings that are non-public, the plaintiff-favoring antifraud provisions of section 12(a)(2) are not available.[8] The Supreme Court's opinion weakens substantive anti-deception relief for plaintiffs, because it eliminates the availability of section 12(a)(2)[9] and relegates plaintiffs to the largely tougher-on-plaintiffs rule 10b-5[10] tests under the implied private right. Oddly enough, publicly enforced antifraud sanctions are still applicable to the non-public transaction context, pursuant to the government-favoring principles of 1933 Act section 17(a)(1).[11]

In the National Securities Markets Improvement Act of 1996,[12] Congress divested states of power to engage in specified types of interventions with respect to certain non-public transactions originated by both issuers and non-issuers. The Act also leaves open the possibility of SEC exemptive rules based on the qualifications of transactors, which will probably be a function of their non-publicness (actual or "constructive," as distinguished below), amongst other things.

Under the 1934 Act, pursuant to section 12(h),[13] the non-public quality of the holders of the issuer's outstanding securities is one of the grounds upon which issuers can escape section 12 registration[14] or 15(d) periodic reporting,[15] and some or all of the ensuing obligations of itemized disclosure under that Act.

Thus, we repeatedly see that non-publicness plays a crucial role in choosing not to intervene in one way or another, or in limiting the

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[5] 15 U.S.C. § 77b(11).
[6] *Id.* § 77d(1).
[7] *Id.* § 77b(3).
[8] *See* Gufstafson v. Alloyd Co., 513 U.S. 561 (1995).
[9] § 77*l*(2).
[10] 17 C.F.R. § 240.10b-5 (2000).
[11] § 77q(a)(1).
[12] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[13] § 78*l*(h).
[14] *Id.* § 78*l*(a).
[15] *Id.* § 78o(d).

availability of sanctions. And beyond these separate issues of choosing types of informational intervention and types of enforcement mechanisms, there is the more refined question of how to adjust, in light of the non-public quality of transactors, the substantive elements of directives, prohibitions, sanctions, and enforcement mechanisms.

I proposed some reasons—and they cut across Professor Fox's presentation in some ways, but not in others—why non-publicness should be given significance in choosing an interventionist versus non-interventionist approach and, within the interventionist approach, as regards coverage, sanctions, and elements of rules. Non-publicness refers mainly to the characteristics of transactors. As a function of many judicial and administrative interpretations, there are principally two types of non-public transactors.

First, there is the kind exhibited by the generally sophisticated type of person—the person who has an S-1[16] in his or her head by virtue of knowledge, training, and experience. These are viewed as non-public persons with respect to any securities. They can come "cold call" to transactions in any security and, to use the Supreme Court's language, "fend for themselves,"[17] because they know what questions to ask and how to get answers. So this is "general" non-publicness. Venture capitalists and some "angels," among others, fit this description.

But there is another kind of non-publicness, and it refers to the type of person who already has a naturally accrued knowledge of the issuer, say, by being involved in the activities of the issuer. I call that "knowledge-of-specific-issuer" non-publicness.

These two different kinds of non-publicness may have different ramifications. I sketch here some of the high points of a proposed model for choosing between means of curing "information failures," and how non-publicness may fit into that model.

When we think about law-supplied interventions such as itemized-disclosure or anti-deception prohibitions and directives and their various attached sanctions, we ask some very important methodological questions: What ultimate goals are we trying to achieve by the intervention and, a correlative question, why might non-interventionist mechanisms do as good as or better a job of achieving objectives? We must identify what desirable objectives—such things as allocation of resources to production or gains from exchange—are frustrated by the effects of information failures on transactions, and what are the costs of those frustrations if left undiminished? We might call those costs "frustration-of-objectives" costs.

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[16] 17 C.F.R. § 203 Form S-1 (2000).
[17] SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

But we must also remember that intervention, as I have just said, is only one means of reducing, by curing information failures, the frustration of objectives. There are private strategies, that is, express contractual arrangements and natural conditions and incentives that can and will be used in the absence of intervention. Even in the absence of intervention, those who are selling securities in markets affected by information failure will face costs of private (that is, non-interventionist) curative means, such as pushing or pulling of information (about the uncertain attributes and the future behavior of economic factors and agents, such as firm managers), monitoring of various sorts coupled with express incentives and disincentives, discounting to cover exposure to costs, and sometimes even rationing. Interventionist and non-interventionist means of curing information failure will each have its own "implementation costs." Intervention will displace some of the private strategy costs with its own compliance and enforcement costs, and part of those enforcement costs will be private rights of action, civil governmental actions, and criminal actions, alone or in combination.

In order to choose between interventionist and non-interventionist regimes and, within the interventionist schemes, the forms of sanctions and the elements of rules, the justificational exercise is to compare intervention with non-intervention in terms of the total costs of each. The total costs of each regime is a "combination" of two statistics. One is the *residual* frustration-of-objectives cost, namely, that amount of such costs which the particular regime has not been able to squeeze out. The other is the implementation costs.

Another important but often overlooked observation is that there may be an opportunity cost involved on the "implementation cost" side of curing information failures, and that cost may not be a purely private one for the issuer or a narrowly social one for securities transactors. It may be a broadly social cost caused by public dissemination of proprietary information that may, if the reverberative effects of the preventive mechanism are traced carefully over time, reduce, from a beforehand point of view, the incentive to produce that information in the first place and, in the process, deprive consumers of the benefits of such things as new technologies and new ways of deploying resources.

The stronger the non-public quality of the transactors, the more likely it is that the combination of costs that I have just described will be lower without the intervention than it will be with intervention.

The problem is that there are differing degrees of non-publicness, and we see that cropping up, among other places, in the so-called "accredited investor" tests that are presently in the rules under the 1933 Act. These are tests that are based on transactor income and wealth, which are viewed as proxies or non-public quality of transactors, without direct inquiry into the types of non-publicness exhibited by the transactors. To the extent that such indirect tests are not good proxies for non-publicness, nothing that I have said easily follows. For example, I have two doctor children. Upon becoming "attendings," suddenly their compensation ran into the hundreds of thousands of dollars annually. They will soon be "accredited investors." But they are not "angels" in any sense of that word, either in the sense that parents use it or (more relevantly) in the sense we have used it today to talk about a certain category of non-public transactors. And so, when we talk about "private equity" and introduce the concept of non-publicness, with all the ramifications that flow from it, we have to be careful.

In the parlance of the financial community today, "venture capital" is being separated from "private equity" in the very closest meanings on those phrases. The venture capital template is being distinguished from these other so-called "private equity" concepts, where very likely public persons are showing up as presumptively non-public.