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Case Western Reserve Law Review

Volume 51 | Issue 3 Article 12

2001

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Recommended Citation

Joseph A. Grundfest, *The Ambiguous Boundaries between Public and Private Securities Markets*, 51 Case W. Rsrv. L. Rev. 483 (2001)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol51/iss3/12

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THE AMBIGUOUS BOUNDARIES BETWEEN PUBLIC AND PRIVATE SECURITIES MARKETS

Joseph A. Grundfest[†]

INTRODUCTION

Read literally, United States securities laws draw a sharp distinction between securities that are registered with the Securities and Exchange Commission ("SEC") and all other financial instruments. Only registered securities can be bought and sold by retail investors in major markets, such as the New York Stock Exchange and Nasdaq. It might thus seem that if a security is not registered with the SEC, the financial risks and rewards associated with its ownership are inaccessible to United States retail investors who must trade in the public markets. Read literally, United States securities laws also seem to impose significant constraints on an issuer's ability to conduct private placements in close temporal proximity to public offerings, or to create private instruments with pricing features that render them overly "fungible" with publicly traded instruments.

Appearances can be deceiving. The universe of securities not registered with the SEC includes a huge array of instruments that are issued by foreign entities. It also contains many billions of dollars worth of instruments that are privately placed within the United States by domestic and foreign issuers alike. Through a variety of market innovations, all of which are entirely legal, even the least sophisticated United States market participant is today able to obtain financial exposure to many foreign and domestic financial instruments that cannot be directly sold to or traded among these same retail investors. Moreover, the private placement market is rife with privately placed instruments that are placed contemporaneously with public offerings, or that have pricing features that render them, from a financial perspective, highly "fungible" with publicly traded instruments.

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Much of this flexibility has evolved because of responsible, pragmatic regulation by the SEC and its staff, combined with vibrant innovation in the capital markets. The result is a situation in which the bright-line distinction between registered and unregistered securities is often (but not always) reduced to a pricing and marketing technicality. The sharp distinction between registered and unregistered instruments that exists in the law is thus often far less discernable in the real world.

This presentation suggests that the SEC and students of securities markets should recognize this reality of modern capital markets. Policy makers need not cleave so closely to the formalistic notion that there is a bright-line distinction between registered public offerings on the one hand and unregistered private placements and offshore instruments on the other. The Commission should therefore aggressively pursue a functional approach and only impose registration costs on the capital formation process when, consistent with the Supreme Court's decision in *SEC v. Ralston Purina*, there is reason to believe that investors who cannot otherwise "fend for themselves" will efficiently benefit from the imposition of registration requirements.[1] As an example of an appropriate liberalization that would not reduce investor safeguards one whit, the Commission could, as explained below, relax some of the limitations inherent in the Squadron Ellenoff[2] and Black Box[3] no-action letters. It could also clarify that it is permissible for private placement issuers to rely on pricing and offering mechanisms that are contingent on subsequent public offerings.

Part I of this very brief presentation provides a capsule summary of the registration requirement of the Securities Act of 1933.[4] Part II describes a sample of instruments and transactions that are entirely legal but that have economic consequences functionally equivalent to the offering of unregistered securities to retail investors, or to the commingling of public and private offerings. The samples described in Part II do not purport to constitute a complete description of this market. Part III concludes with some pragmatic observations about the implications of current market realities for the evolution of public policy in this area. It suggests that doctrinal precision can and should responsibly take a back seat to market reality and to the efficient protection of investors who, as the Supreme Court put it, cannot "fend for themselves" in these transactions.

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[1] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). For a similar recent view expressed by another former Commissioner of the SEC, see Roberta S. Karmel, *Integration of Public and Private Offerings*, N.Y. L.J., Apr. 19, 2001, at 3.

[2] Squadron, Ellenoff, Pleasant & Lehrer, 1992 SEC No-Act. LEXIS 363 (Feb. 28, 1992).

[3] Black Box Inc., 1990 SEC No-Act. LEXIS 926 (June 26, 1990).

[4] For a more detailed discussion, see generally 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 57-684 (2001).

I. THE BRIGHT LINE SEPARATING REGISTERED AND UNREGISTERED SECURITIES

The black letter law regarding the sale and resale of securities in the United States is straightforward. All sales or resales of securities must be registered with the SEC, unless the transaction or security is expressly exempt. The person claiming the benefit of the exemption bears the burden of proof to demonstrate that the exemption is available. The statute provides for several significant exemptions to this remarkably broad registration requirement. Indeed, modern capital markets are able to function in a liquid form only because of the sweep of these exemptions.

From an issuer's perspective, the most important exemption is the private placement provision of section 4(2). In *SEC v. Ralston Purina*,[5] the Supreme Court explained that the purpose of the private placement exemption is to exempt transactions involving sales to persons who, because of their lack of access to information about issuers, or because of their inability to protect their own financial interests, cannot "fend for themselves."[6] The Court expressly observed that there is no quantitative limit to the number of investors who may participate in such an offering or on the dollar value of the securities that could be sold in such a private placement—again, provided that the investors in the transaction can fend for themselves.

The SEC provided greater regulatory precision to this exemption when it adopted rule 506 of Regulation D.[7] Rule 506 permits a private placement of an unlimited dollar value of unregistered securities to an unlimited number of "accredited" investors and to no more than thirty-five unaccredited investors.[8] Accredited investors can be loosely defined as individuals with net worth in excess of one million dollars, without regard to their financial sophistication or ability to fend for themselves.[9] Unaccredited investors who are permitted to participate in these rule 506 private placements must, however, be able to fend for themselves either independently or with the assistance of a "purchaser representative."[10]

If an offering does not qualify as a proper private placement, if no other exemption is available, and if the offering has not been registered, then dire consequences can follow. In particular, the purchaser of an unregistered security has the right to return the security to the seller for the initial purchase price even if there has been no

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[5] 346 U.S. 119.
[6] *Id.* at 125.
[7] *See* 17 C.F.R. § 230.506 (2000).
[8] *See id.* § 230.506(b)(2)(i).
[9] *See id.* § 230.501(a)(5).
[10] *See id.* § 230.506(b)(2)(ii); *id.* § 230.501(h).

material misrepresentation or omission in the offering process.[11] This rescission right is equivalent to offering a put option to the purchaser where the option gives the purchaser a one-year money-back guarantee in the event that the security's price declines, even if through no fault of the seller's. This potential rescission right creates contingent liabilities that can adversely impair an issuer's financial statements. It also can cause difficult disclosure issues in connection with a public offering of the issuer's securities.[12]

To this point, the statutory and regulatory design seems clear. On one side of a great divide stand registered securities that can be sold to investors who are unable to fend for themselves and who are not millionaires. These investments can be freely traded in liquid, open markets such as the New York Stock Exchange and Nasdaq. On the other side stand unregistered instruments that can safely be offered only to those who can fend for themselves or who are millionaires. If an issuer errs and fails to register an offering when no exemption is available it can be subject to significant liability.

II. THE REALITIES OF THE MARKETPLACE

The reality of the marketplace is, however, very different from a world that assiduously reflects this bright-line distinction. The United States's public securities markets are chock-a-block full of financial instruments that permit small, unsophisticated investors to participate in the economic risks and returns generated by unregistered securities. Recent market transactions also allow issuers in private placements to engage in contemporaneous or temporally contiguous public offerings, or to receive private placement valuations that reflect subsequent initial public offerings. The markets thus readily commingle publicly available registered-security risk with non-registered risk.

Significantly, the ease with which the markets currently leap the barrier between registered and unregistered instruments raises no practical material investor protection concern of which I am aware. To illustrate, consider the four following examples of instruments and transactions that jump the registered/unregistered boundary, all with beneficial effect: (1) the offering of unregistered offshore equity risk through actively managed mutual funds and other collective investment vehicles; (2) the recent emergence of private placements with valuations that are contingent on the pricing of a future initial public offering; (3) the evolution of PIPEs transactions (private investments in public equities); and (4) the Black Box and Squadron Ellenoff let-

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[11] *See* Securities Act of 1933 § 12(1), 15 U.S.C. § 77*l*(1) (1994). *See also* BLOOMENTHAL, *supra* note 4, at 2-19.

[12] *See* BLOOMENTHAL, *supra* note 4, at 90-91.

ters, particularly viewed in conjunction with the market conditions that recently caused the SEC to adopt rule 155.[13]

A. Mutual Funds and Collective Investment Vehicles

Mutual funds and other collective investment vehicles, such as insurance policies and defined benefit retirement funds, probably constitute the largest mechanism through which retail investors are able to invest indirectly in securities that are not registered with the SEC. To illustrate, consider the fact that there are a large number of actively managed mutual funds registered with the SEC that claim to have international investment objectives and that invest many billions of dollars in securities traded only on offshore markets. Each of these funds invests the lion's share of its portfolio in foreign markets where issuers have not registered their shares with the SEC and where those issuers do not comply with United States Generally Accepted Accounting Principles. Thus, investors who purchase any of these mutual funds acquire exposure to a portfolio of individual securities, none of which could be sold directly to them. Similarly, holders of insurance policies issued by insurers engaged in international investing and pensioners whose pension funds are invested abroad also acquire exposure to unregistered foreign security risk that they could not directly acquire in United States markets.

This situation is not a cause for alarm, and there have been no suggestions of material harm or wrongdoing as a result of this market process. Indeed, this situation is easily reconciled with some of the technical requirements of Regulation D. In particular, rule 506 of Regulation D provides that unaccredited investors are able to purchase in private placements if they themselves, or together with a purchaser representative, are "capable of evaluating the merits and risks of the prospective investment."[14] Viewed from this perspective, a mutual fund manager, insurance company portfolio manager, or pension fund investment fiduciary fulfills the role of "purchaser representative" for the retail investor. The public trading of unregistered securities so facilitated through the mechanism of a collective investment vehicles is therefore entirely consistent with the logic of the SEC's own private placement regulations under rule 506, once we appreciate that the professional fund manager is a functional equivalent of the Regulation D "purchaser representative."

B. Private Placements That Reflect Public Market Values

Another intriguing development that blurs the distinction between public offerings and private placements is the emergence of

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[13] *See* 17 C.F.R. § 230.155.

[14] *Id.* § 230.506(b)(2)(ii).

private placements that are offered at prices contingent upon public offerings that have not occurred as of the date of the private placement, and as to which no public offering can even be guaranteed to occur. Consider, for example, the private placement on October 20, 2000, of $75 million of 5¼% convertible subordinated notes due 2005 issued by Mayan Networks Corporation.[15] The conversion price of the notes was initially set at $38.12 per share, subject to reduction according to the following schedule:

(i) if a Complying Public Equity Offering ("CPEO")[16] occurs prior to November 1, 2001, then the conversion price is reset to the public offering price, if that price is lower than the conversion price;

(ii) if the CPEO occurs prior to November 1, 2002, but on or after November 1, 2001, then the conversion price is reset to the lesser of 90% of the public offering price, or 90% of the conversion price;

(iii) if the CPEO occurs prior to November 1, 2003, but on or after November 1, 2002, then the conversion price is reset to the lesser of 80% of the public offering price, or 80% of the conversion price; and

(iv) if the CPEO has not occurred prior to November 1, 2003, then the conversion price is reduced to 35% of the otherwise applicable conversion price.[17]

Therefore, in the event Mayan is able to complete a qualifying public offering prior to November 1, 2003, the purchasers of these notes will be guaranteed a right to acquire IPO exposure at the IPO price or lower. Given that this instrument was structured at a time when the IPO market for optical telecommunication companies, such as Mayan, was still "hot," and given that there was then an expectation of a price "pop" in the immediate aftermarket, these privately placed securities provided Mayan with an opportunity to raise capital by pre-selling a potentially "hot" IPO that had not yet occurred.

From the purchaser's perspective, the offering was also potentially attractive because it afforded a potentially large number of acquirers, otherwise unable purchase in the IPO, an opportunity to acquire at a price no worse than the subsequent offering price. Thus, rather than be forced to purchase at a premium to the IPO price in the aftermarket, purchasers of these privately placed securities acquired

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[15] Mayan Networks Corp., Confidential Offering Circular (Oct. 20, 2000) (not formally published manuscript, on file with the *Case Western Reserve Law Review*).

[16] A CPEO is defined as "[t]he first firm commitment underwritten public offering of common stock of Mayan Networks in which Mayan Networks shall have raised at least $50,000,000 in gross proceeds from the offering." *Id.* at 57.

[17] *See id.* at 6.

an opportunity to purchase at a discount to the IPO price in the pre-IPO market. Moreover, because the conversion price declined over time, the notes were structured so as to provide Mayan with an incentive to complete a public offering as quickly as possible—an objective consistent with the goals of purchasers who want to hold Mayan's common stock, not its subordinated notes.

But what of the federal securities law concern that these private placed securities constitute a *de facto* offering at a price that is contingent upon a public offering as to which no registration statement had yet been filed with the SEC? Whatever metaphysical issues might have been raised by this observation, they should (and in fact did) have no practical impact on the offering process because all the purchasers in this offering were able to fend for themselves quite nicely. Indeed, because the offering was structured to comply with rule 144A,[18] the entire offering was initially purchased by the underwriter, a sophisticated broker-dealer with substantial knowledge of the issuer's business.[19] Subsequent resales were restricted to "qualified institutional buyers," who, pursuant to rule 144A, must in general hold securities portfolios of $100 million or more.[20] Thus, everyone contemplated to be in the chain of ownership would be a sophisticated, well-financed investor who would not need the protection of the registration process. The transmutation of public offering pricing risk to the private placement market here does not, as a matter of policy, raise any of the issues implicated by the Securities Act of 1933.

C. PIPEs Transactions

A PIPEs transaction describes a "private investment in public equities"—in other words, a private placement of equity securities by issuers who already have a class of publicly issued and registered shares.[21] Historically, these transactions were most commonly used by biotech issuers or other technology firms with significant demands for additional capital but with market capitalizations too small to comfortably allow for follow-on offerings large enough to provide the needed capital.

More recently, however, large leveraged buyout firms began purchasing PIPEs. These private placement transactions are uncon-

[18] 17 C.F.R. § 230.144A.

[19] Mayan Network Corp., *supra* note 15, at 83.

[20] *See* 17 C.F.R. § 230.144A (a)(1)(5). *See also* BLOOMENTHAL, *supra* note 4, at 538-41.

[21] *See, e.g.*, Erica Copulsky, *Novel Solutions: Cash-Rich LBO Firms Are Being Forced to Go Outside the Box to Find New Ways to Put All Their Money to Use*, INVESTMENT DEALERS' DIG., Mar. 22, 1999, at 22; John LeClaire & Kevin Dennis, *Going Private—Private Equity Investors Discover Public Market Orphans*, VENTURE CAP. J., Nov. 1, 1999, at 44; Debra Sparks, *Return of the LBO*, BUS. WK., Oct. 16, 2000, at 130.

troversial, in my view, from a securities law perspective. The purchasers are highly sophisticated organizations with a well-established ability to fend for themselves. The controversy generated by these instruments results instead from the poor aftermarket performance of some of these transactions—particularly in the telecommunications sector[22]—combined with the fact that investors in LBO funds pay 20% overrides, and that many investors expect that their funds will be put to work in classic LBO-style active restructurings rather than more passive PIPEs-style transactions.

D. SEC No-Action Letters and Rule 155

Securities law concerns also arise when an issuer seeks to conduct a private placement (a) while it is in registration for an IPO, (b) just before the filing of a registration statement, or (c) just after the withdrawal of a registration statement.[23] In the Black Box and Squadron Ellenoff no-action letters, the staff provided comfort to some issuers engaged in concurrent private placements and public offerings. These no action letters, however, specifically describe circumstances involving a limited number of appropriate investors, such as (a) 35 or fewer purchasers, consisting of QIBs (qualified institutional buyers) and no more than three institutional investors who are not QIBs, or (b) no more than four purchasers, all of whom are non-QIB institutional investors, plus up to three additional non-QIB institutional investors who are pre-existing security holders of the issuer.

From a policy perspective, it is legitimate to ask whether these restrictions are entirely necessary. If all participants in a transaction are sufficiently capable of fending for themselves, then what legitimate purpose related to the function of the registration requirements is served by the numerical limitations inherent in the Black Box and Squadron Ellenoff letters?

The SEC's recent adoption of rule 155[24] can be similarly described as a welcome liberalization that may not reach as far as it could or should. The rule provides for safe harbors from integration concerns in the case of (a) registered offerings following abandoned private placements, and (b) private placements following abandoned public offerings.

As the SEC explained in the rule 155 adopting release, rapid changes in market conditions can cause issuers to decide to terminate private placements and then, very quickly, to pursue a public offer-

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[22] *See, e.g.*, Sparks, *supra* note 21, at 130 (citing losses by LBO fund Hicks Muse in a PIPEs offering by ICG Communications at $29 per share that subsequently traded down to $0.50 per share).

[23] *See, e.g.*, BLOOMENTHAL, *supra* note 4, at 481-93.

[24] 17 C.F.R. § 230.155.

ing.[25] Market conditions can also cause an issuer to pursue a private placement almost immediately upon the withdrawal of a registration statement. In both cases, rule 155 requires a thirty-day "cooling off" period between the private placement and the public offering. The goal of the cooling-off period is to assure a "clean break" between the public and private phases of the offering. In both cases, however, if all the investors in the private placement are able to fend for themselves, then the thirty-day cooling-off period would seem to be a formality that serves no functional purpose under the Securities Act. Indeed, the thirty-day waiting periods contemplated by rule 155 can then only raise the cost of capital formation without enhancing investor protection.

III. POLICY IMPLICATIONS

The policy implications of this analysis are clear. The capital markets have already generated a broad array of techniques that can be used by retail investors in the public markets to obtain access to the risks and returns reflected in foreign and domestic securities that have not complied with United States registration, accounting, or disclosure requirements. In the professional market, a broad array of techniques allow sophisticated investors to engage in private market transactions that are financially commingled with publicly registered risks and returns, but that technically constitute distinct securities.

Because the capital markets readily generate substitutes in the public markets for private market risk, and in the private markets for public market risk, the SEC is well advised not to elevate form over substance. It should instead focus its regulatory efforts on measures that efficiently protect investors who cannot otherwise fend for themselves. In particular, unnecessarily aggressive interpretations of the integration doctrine can add to transactions costs without otherwise contributing to investor protection. This danger arises most apparently when cooling-off periods are imposed to protect private placement investors who can fend for themselves and where the cooling-off period can only increase capital formation costs. The capital formation process need not be so complex, and the time is ripe for pragmatic simplification of a doctrine that purports in theory to segregate public from private markets but in practice only makes life more complicated and expensive for all involved.[26]

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[25] Integration of Abandoned Offerings, Exchange Act Release No. 33-7943, 2001 SEC LEXIS 166 (Jan. 31, 2001) (to be codified at 17 C.F.R. § 230.155).

[26] *See also* Karmel, *supra* note 1, at 7 ("The regulatory morass that Section 5 compliance has become is a cost of capital raising that merits thorough reexamination and simplification.").