SEC Private Placement Rule Threatens to Put Investors at Great Risk

BY JACK HERSTEIN, NASAA

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The SEC on Wednesday is expected to release a rule proposal to allow the general solicitation and advertising of private placements made under Reg D Rule 506.

Given the complexity of the issues involved in the changes to Rule 506, plus the enormous impact those changes will have on the investing public, NASAA has strongly urged the SEC to consider a simple question: How does this help investors?

Perhaps the greatest persistent threat to investors—and one that is expected to grow as a result of the JOBS Act—involves private offerings made under the SEC's Regulation D Rule 506.

In the most recent survey of state securities regulators, fraudulent private placement offerings were ranked as the most common product or scheme leading to investigations and enforcement actions.

Regulation D Rule 506 is an exemption under federal securities laws that allows private placements to be sold to investors without registration. By definition, these are limited investment offerings that are highly illiquid, generally lack transparency and have little regulatory oversight.

While Regulation D Rule 506 offerings are used by many legitimate companies to raise capital, these investment offerings are high-risk and may not be suitable for many individual investors.

The JOBS Act significantly relaxed the restrictions on the manner in which Reg D Rule 506 offerings can be marketed to the general public, eliminating the previous ban on general solicitations or advertising.

Once the rules implementing this change are finalized by the SEC, investors will begin to see a variety of advertisements related to private placement offerings, even though only a very small percentage of the population will be eligible to invest.

Many may think the changes to Rule 506 are simple and straightforward, and we are aware of the pressure the commission is under to act quickly—on this and many other JOBS Act provisions.

The JOBS Act contains a 90-day limit for the changes to Rule 506, yet many of the rulemakings required by the Dodd-Frank Act are long overdue.

We have encouraged the SEC to prioritize investor-protection rules ahead of the exemptions in the JOBS Act, and we appreciate that the agency is resisting pressure to act hastily, especially where ill-considered changes could have such devastating impacts on investors.

But these changes also could come at a significant cost, including:

The losses sustained in low-quality investments marketable under the newly expanded Rule 506 but would never have been sold successfully in a registered offering that required full disclosure, and

The amount investors will lose in fraudulent offerings as a result of the changes to Rule 506. For example, the Justice Department recently indicted two executives of Provident Royalties in connection with a $485 million fraud against 7,700 investors in private placements. In 2011, states brought more than 200 enforcement actions for fraudulent Rule 506 offerings.

Unfortunately, if the new rule fails to strike the proper balance between capital formation and investor protection, the number of frauds and the amount of damages only can be expected to increase when it becomes easier to solicit victims under Rule 506.

About the Author

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