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Private Offerings and Public Ends: Reconsidering the Regime for Classification of Investors under the Securities Act of 1933

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Investment in private offerings of securities, those that take place off of public exchanges and that are exempt from federal disclosure rules applicable to public offerings, is primarily available to investors on the basis of wealth. The wealthy are presumed sophisticated enough to make informed decisions about what to buy without mandatory disclosures applicable to public offerings. Yet the financial crisis of 2008 made clear that wealthy and ostensibly sophisticated investors can make tremendous mistakes and suffer enormous losses. Those losses are a problem when the investor serves a public goal, such as providing income to public sector employees. This Article argues that investment in private offerings by institutions serving a public mission should be limited to ensure that public ends are protected.

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JONATHAN D. GLATER*

I. INTRODUCTION

To an ever greater degree, we rely on investments in securities[1] to achieve socially desirable public goals, such as enabling saving for retirement.[2] One might expect that as a result, investment activity of entities managing workers' retirement savings, for example, might be narrowly circumscribed to ensure they achieve their goal. Yet federal securities laws do not provide for consideration of an institutional investor's *raison d'être* in determining whether that institution can or should buy securities in private offerings. Private offerings are potentially riskier transactions that take place off of public exchanges, are typically[3] available by invitation only, and are exempt from the formal federal

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1 *See* William J. Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, 135 MONTHLY LAB. REV. 3, 3 (Dec. 2012), http://www.bls.gov/opub/mlr/2012/12/art1full.pdf [http://perma.cc/E8AW-XPJ8] (reporting that only ten percent of all private sector businesses offer defined benefit retirement plans). Additionally, more than two-thirds of workers in 2011 depended on defined contribution plans, such as 401(k) plans, for retirement income. *FAQs About Benefits—Retirement Issues*, EMP. BENEFIT RES. INST., http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14 [http://perma.cc/BH9V-GAWN] (last visited Jan. 27, 2015).

2 Another example is saving to pay for education expenses. But there are also institutions that serve the needs of third parties and invest funds in financial markets to support the business, like insurance companies. *See infra* note 70 and accompanying text (discussing insurer investments and the potential need for enhanced regulation).

3 Relatively new regulations permit the advertising of opportunities to purchase unregistered securities without triggering the registration requirements otherwise applicable, provided that all purchasers of the securities sold are "accredited investors." 17 C.F.R. § 230.506(c)(2) (2014). "Accredited investors" include banks, insurance companies, investment companies, employee benefit plans, and other entities with assets under management with values above specified thresholds. *Id.* § 230.501(a) (2013).

disclosure rules applicable to public offerings.

Institutional investors qualify as "accredited" and may participate in private offerings if they meet certain simple wealth thresholds, regardless of their ability to evaluate risk or to absorb potential losses. As many as thirty-five investors that are not accredited but that are "sophisticated" may also participate in private offerings.[4] The rules identifying who can invest in private offerings thus reflect a belief in the premise that wealthy investors have the expertise to manage risk well, as well as the premise that the losses they may suffer will not have broader systemic or societal impact.[5] This Article argues that pre-crisis investor missteps should provoke very critical questioning of both these premises. The Article contends that these standards are overly permissive and that as a result they endanger investors, the system in which they operate, and—most significantly—the public ends that some institutional investors serve.

Court filings in cases filed by investors that have lost significant amounts on securities purchased in private offerings illustrate the problem. Court documents show that very wealthy investors in private offerings bought securities, the workings or potential consequences of which they did not understand, or chose to ignore. Some of these investors served public goals, such as managing retirement savings of government employees. Consider the experience of the San Diego County Employees Retirement Association (SDCERA), which as of this writing manages a pension fund tasked with providing retirement benefits to nearly 37,000 current and former county employees.[6] The value of the Association's assets reached $8.5 billion in 2012.[7] In September 2005, SDCERA invested $175 million in Amaranth Partners LLC, a Connecticut-based hedge fund,[8] in a private offering. Amaranth collapsed a year later after losing $6.5 billion in a matter of weeks.[9] SDCERA lost well over $100

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[4] *See id.* § 230.506(b)(2)(ii).

[5] The former point is explicit in Supreme Court commentary on exempt offerings of securities; the latter is implicit, but has not been directly addressed. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[6] *Facts at a Glance*, SAN DIEGO CNTY. EMP. RET. ASS'N 1 (Jan. 2013), https://web.archive.org/web/20130522003448/http://www.sdcera.org/PDF/Facts_at_a_glance-2012.pdf [https://perma.cc/J2A5-8S3F]. At the time of the pension fund's investment in Amaranth, it served approximately 33,000 people. *Id.*

[7] *Id*. at 2.

[8] Hedge funds are entities created with the goal of combining investment positions in different types of assets, with a goal of earning the maximum return in various market conditions. *Hedge Funds*, U.S. SEC. & EXCHANGE COMM'N (Dec. 4, 2012), http://www.sec.gov/answers/hedge.htm [http://perma.cc/9897-NKW6].

[9] Jenny Anderson, *After Loss, Hedge Fund Will Close,* N.Y. TIMES, Sept. 30, 2006, at C6.

million of its original investment[10] and filed a lawsuit accusing Amaranth of securities fraud: SDCERA claimed it had been induced to invest in Amaranth by false and misleading statements about the fund's investment strategy.[11] "SDCERA's investment in the Fund would never have even occurred—and would certainly have been withdrawn—but for . . . repeated misrepresentation of the Fund as risk-managed, diversified, and conservative."[12] A federal judge dismissed SDCERA's claim, finding that SDCERA was a "sophisticated investor" and, as a result, could not claim after the fact not to have understood, or not to have been able to monitor, the fund's conduct.[13] In other words, SDCERA's wealth qualified it to invest in the private offering, and it either did or should have known better.

Under the criteria typically applied to private placements,[14] the judge was correct and the plaintiffs were sophisticated investors. This is so even though the complaint and briefs in the case suggest that the investors did not act in a sophisticated fashion; they attempted neither to verify the representations allegedly made by Amaranth officers nor to reconcile those representations with the language of the contract with the fund.[15] The plaintiffs were unsuccessful in their federal action alleging securities fraud because they could not establish that they reasonably relied upon alleged misrepresentations by Amaranth and its officers.[16] And as a consequence, the financial resources available to SDCERA to satisfy its obligations to

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[10] Memorandum of Law in Opposition to Defendants' Motions to Dismiss the Complaint for Failure to State a Claim at 17, San Diego Cnty. Emp. Ret. Ass'n v. Maounis, 749 F. Supp. 2d 104 (S.D.N.Y. 2010) (07 Civ. 2618 (DAB)), 2007 WL 2960234.

[11] *See id*. at 1 ("[Defendants] expressly portrayed the Fund as a multi-strategy, risk-managed investment that eschewed the promise of 'home run' returns from risky gambles in favor of modest gains achieved through diversification, hedging and active risk management.").

[12] *Id*. at 2.

[13] *See Maounis*, 749 F. Supp. 2d at 120–21 (explaining how SDCERA's status as a sophisticated investor, and efforts by its agents to read and sign the Fund's Subscription Agreement, made its claim of reliance on the Fund unreasonable).

[14] *See* 17 C.F.R. § 230.506(b)(2)(ii) (2014) ("[A sophisticated investor] has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."); *see also* Jonathan D. Glater, *Hurdles of Different Heights for Securities Fraud Litigants of Different Types*, 2014 COLUM. BUS. L. REV. 47, 74 (explaining how courts have not identified fixed markers of sophistication).

[15] *See Maounis*, 749 F. Supp. 2d at 109–10 (explaining that from December 2004 to September 2005, SDCERA alleged that its due diligence with regards to Amaranth consisted solely of conversations and that it relied on representations by the Fund).

[16] *See* Terra Sec. ASA Konkursbo v. Citigroup, Inc., 450 F. App'x 32, 34 (2d Cir. 2011) ("'Under New York law, for a plaintiff to prevail on a claim of fraud, he must prove . . . a material representation or omission of fact,' as well as 'reasonable reliance on the part of the plaintiff.'" (quoting Schlaifer Nance & Co. v. Estate of Warhol, 119 F.3d 91, 98 (2d Cir. 1997))); Bremanger v. Citigroup Global Markets Inc., 2013 WL 1294615, at *13 (S.D.N.Y. 2013) (citing *Terra* for an example of unreasonable reliance).

tens of thousands of people were diminished.[17]

The losses suffered by SDCERA and other institutional investors with tens or hundreds of millions of dollars under management highlight the problem in securities law that is the focus of this Article: the regulations classifying investors to whom sellers may offer securities through private placements do not function as an effective screen. The limits neither protect investors from transactions that are too complex and/or risky for them, nor do they protect the achievement of the public goals that many institutional investors may serve. The consequences of these failures were evident in the wake of the financial crisis of 2008, which demonstrated that the risks of widespread, poor investment outcomes extend well beyond the parties involved in particular transactions. This Article describes the shortcomings of the criteria[18] that determine which investors may participate in private offerings and identifies investor characteristics that should better predict investor acumen. But the Article's greater contribution consists of a proposal to adopt a novel criterion to evaluate the extent to which an investor should be able to purchase in a private offering. That criterion, which the Article refers to as "financial resilience," is a measure of an investor's ability to absorb losses while still achieving any public end that the investor serves.

This notion of resilience incorporates into the analysis of an investor's fitness to invest in a private placement the uses to which the money and any return on its investment are to be put, and reframes the question of investor sophistication—an exercise in classification—as an essential element in a larger, more fundamental debate over what it means for an entity to be "public." The Article consequently emphasizes the extent to which the current regime that identifies investors eligible to participate in certain transactions functions in a particular historical moment, a moment in which the United States has reallocated a greater share of the responsibility for achievement of meaningful public goals away from the government.

Adoption of the concept of financial resilience sets this Article's discussion and proposal apart from those of prior scholars who have examined the difficulty of measuring investor sophistication and takes into account both changes in financial market participation and the greater role that institutional investors play in serving public goals. More than in the past, public pension funds, for example, which workers depend on, buy

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[17] By how much, of course, is difficult to assess; this is not information included in court filings, for example.

[18] Or criteria based on income or assets under management, as provided in other provisions under Regulation D of the Securities Act of 1933. *See* 17 C.F.R. §§ 230.501(a), 230.506(b)(2)(ii) (2014) (defining accredited and sophisticated investors).

less liquid securities directly through private offerings[19] and indirectly by investing in entities, like hedge funds, that invest in private offerings.[20] The 2008 financial crisis makes plain that resilience matters because excessive investment in risky securities can contribute to systemic risk;[21] when large financial companies suffer losses that prevent them from performing on their obligations, the effects ripple across markets.

This Article is one step in a larger project exploring the implications of the evolution of financial markets, using the financial crisis of 2008 as a point of entry.[22] A prior article examined post-financial crisis securities fraud litigation, which affords a means of protecting investors ex post, and argued that the legal regime governing such lawsuits favors investors in private offerings relative to investors that purchase in public offerings.[23] The disparity, according to the prior article, was unjustified and weakened an incentive for private placement investors to investigate transactions adequately ahead of time.[24] This Article in turn focuses on the regime intended to protect investors ex ante from entering transactions beyond their capacity.[25] A future article will analyze alternative means of limiting the participation of particular types of investors in private offerings, such

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[19] *See* Gretchen Morgenson, *How You Can Pay Millions and Lag Behind the Market*, N.Y. TIMES, Oct. 20, 2013, at BU1 ("[A]lternative investments [such as hedge funds and private equity funds] now account for almost one-quarter of the roughly $2.6 trillion in public pension assets under management nationwide, up from 10 percent in 2006 . . . . Investments in public companies' shares, by contrast, fell to 49 percent from 61 percent in the period.").

[20] More private equity firms are actively wooing public pension funds as investors, as well. *See, e.g.*, Julie Creswell, *Buyout Firms Are Chasing Sky-High Sums for Next Moves*, N.Y. TIMES, Oct. 15, 2013, at B1 (describing efforts by thousands of private equity firms to attract "state retirement systems, corporate pension funds and wealthy investors" as investors, with a goal of raising $750 billion).

[21] Indeed, systemic risk could properly be viewed as a specific manifestation of the larger problem this Article addresses. The proper functioning of financial markets is itself a public goal, benefitting the larger society, and systemic risk undermines the achievement of that goal.

[22] This is a topic approached from different angles by scholars including Steven L. Schwarcz and Steven M. Davidoff. *See* Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 340–41 (2008) (describing changes in capital markets as a result of growth of private exchanges, the growing role of institutional investors and rapid innovation, and identifying failures of federal securities regulation to keep pace); Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1109 (questioning the efficacy of securities regulation regimes that make disclosure a priority when the financial crisis suggests that purchasers of risky securities did not understand the information disclosed); *see also* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1573–74 (2013) (analyzing changes to securities laws wrought through the JOBS Act of 2012). This Article also attempts to evaluate how well current legal and regulatory mechanisms protect investors and enhance stability in addressing potential securities fraud. This Article contributes to an ongoing discussion of links between financial market evolution and systemic risk, and raises questions about how to prevent the poor decisions that pave the way to a crisis.

[23] Glater, *supra* note 14, at 87–88.

[24] *Id.* at 51.

[25] "Capacity" in this context should be understood to encompass both investor ability to comprehend a transaction and ability to cope with adverse investment outcomes.

as developing a more nuanced and sophisticated definition of fiduciary duty for managers of public pension funds,[26] or enacting legislative restrictions on public pension fund investments at the state level.[27] These articles all reflect the concern that too many investors lacking necessary expertise and/or resources participate in private offerings, and in doing so pose a risk both to the broader financial system and to the achievement of public policy objectives affecting people far from Wall Street.

The discussion that follows has four parts. Part II contends that the proper context for analysis of legislative and regulatory treatment of private offerings is the ongoing, intense debate over the meaning of the designation "public."[28] This Part situates the Article in that discussion, which in the past has focused primarily on the questions of when and why a particular corporate entity should be subject to a particular regulatory regime.[29] This Part argues that the implications of taking into account the public effects of the conduct of a corporate entity, or indeed of any non-governmental entity, extend much farther.

Part III proposes that limits on participation in private offerings appropriately protect certain investors' public missions. This Part provides a concise history of the law and regulations intended to screen investors in private placements and explains the significance, benefits and risks of these transactions in modern financial markets. This Part analyzes the rationale for exemptions to the general requirement that securities be registered. It then identifies problems under the exemption regime and reviews criticisms by scholars who have argued that it fails to address the twin problems of the sophisticated investor who is not actually sophisticated or the investor that, however sophisticated, should not be permitted to take on excessive risk because a negative investment outcome

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[26] An expanded concept of fiduciary duty could force an investor with a public mission to account for the possible effects of a poor investment outcome. Professor David Webber argues for adoption of a more nuanced definition of fiduciary duty in the context of union pension fund investment that may contribute to eventual elimination of union employees' job opportunities. David Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2116 (2014) ("I argue that, in connection with fund investments, public pension trustees' fiduciary duties run to the participants and beneficiaries themselves, and not to the fund alone."). A broader recognition of fiduciary duty could be achieved through litigation under the Employee Retirement Income Security Act. *See* Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 215–19 (2013) (describing potential reforms strengthening the fiduciary duty).

[27] Internal rules, developed by an institution that serves a public mission or by the state whose employees depend on it, could also limit the extent of investment in particular types of securities.

[28] As Professor Hillary A. Sale has put it, "[t]he recent financial crisis has brought the publicness and impact of corporations to the forefront of people's minds." Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 142 (2011).

[29] *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 340–41 (2013) (observing that securities regulation is about more than just investor protection and that regulatory and legislative goals include constraining corporate power).

would compromise its ability to complete its public mission.

Part IV outlines a proposal for adoption of superior criteria regulating access to private offerings, and uses the experience of SDCERA to illustrate how the proposal would apply. The proposal includes an alternative framework for classification of investors based on the investors' prior experience. More importantly, though, the proposal subordinates the determination of expertise on the basis of investor characteristics to protection of any public goal that the investor serves, thus imposing on the current regulatory framework new requirements that take into account the publicness of the investor's mission. This proposal advocates adoption of a more flexible, nuanced version of the restriction on public pension fund participation in private offerings that existed prior to 1989.[30]

Part V concludes.

II. PUBLICNESS

In proposing that the public purpose of investment should affect regulatory restrictions on the transactions an investor can participate in, this Article argues that investment activity that is not currently understood as "public" should be. Consequently, the first step must be clarifying what it means to be public. This Part undertakes that task, beginning by distinguishing the meaning of publicness in the context of corporate and securities law from its meanings in other, broader settings. This Part then traces a more nuanced understanding of publicness in recent scholarship on the classification of corporate entities and contends that adoption of a broader understanding of the concept is not merely appropriate in securities regulation, but is essential.

A. *Public Things*

It is an unfortunate accident that discussion of what it means to be public must confront the classification of a particular corporate form. To be public in the context of corporate and securities law is to be described and defined by law. An entity designated as a "public company" is one in which ownership is widely distributed across the holders of its tradable shares.[31] Status as a public company carries ongoing regulatory obligations, such as the filing of periodic reports intended to ensure that investors have adequate information to decide how to value and whether to purchase the company's shares.[32] The largest public companies, whose

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[30] *See infra* note 186 and accompanying text (describing regulatory changes to permit public pension funds to invest in private offerings).

[31] *Public Companies*, INVESTOR.GOV, http://investor.gov/introduction-markets/how-markets-work/public-companies#.VMpfMcaOKgc [http://perma.cc/3HXK-E3ST] (last visited Sept. 29, 2015).

[32] *See* 15 U.S.C. § 78m (2012).

aggregate shares may exceed some nations' gross domestic product, exist in a media spotlight, and their corporate conduct can have outsize effects on the world economy, as well as on the members of the public.

Attention to the largest companies makes sense given other aspects of the definition of "public." Such public companies are prominent, well-known, observed. They are also accessible,[33] because not only is ownership open to any investor willing to pay the market price, but also because disclosure requirements impose a degree of transparency on the entity. By law, public companies provide details of their governance and financial well-being.

When Congress approved the legislative framework that still shapes modern financial markets in the years after the Great Depression, lawmakers understood all too well the public consequences of investor conduct previously performed beyond the reach of federal law. The consequences of investor mistakes and misconduct "spell[ed] tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort"[34] and prompted the adoption of the Securities Act of 1933 ("Securities Act").[35] The Securities Act sought to protect investors by ensuring adequate disclosure of information relevant to the valuation of a security offered for sale, in order to promote capital formation for the growth of business and restore confidence in financial markets.[36] However, the Securities Act exempted transactions from its registration requirement and formal disclosure regime "where the public benefits are too remote."[37] The 2008 crisis has shown that private offerings are closer to the public than was previously believed.[38]

Unfortunately, perhaps because the landmark Securities Act and the Securities Exchange Act of 1934[39] ("Exchange Act") defined what it means to be a public company, there has been little subsequent sustained legislative and regulatory attention to the question of whether and under what circumstances conduct that could be viewed as private should be understood as public. Rather, consideration of the question has typically occurred in reaction to a crisis and has focused on the proper steps the government should take to avert a similar disaster in the future. The result

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[33] The definition is instructive. The first definition offered by one dictionary is "exposed to general view," and the second is "of, relating to, or affecting all the people or the whole area of a nation or state." Definition of "Public", MERRIAM-WEBSTER UNABRIDGED DICTIONARY, http://www.merriam-webster.com/dictionary/public [http://perma.cc/3JN6-6WHB] (last visited Sept. 14, 2015).

[34] H.R. REP. NO. 73-85, at 2 (1933).

[35] Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

[36] H.R. REP. NO. 73-85, at 1–2 (1933).

[37] *Id.* at 5.

[38] *See infra* note 108 and accompanying text (describing the impact of the financial crisis on public pension funds).

[39] 15 U.S.C. §§ 78a–78pp (2012).

has been the adoption of new laws and regulations seeking to correct perceived failures by specific individuals and entities—commercial or investment banks, for example—to consider the very public, social harms they caused. But such policy responses have not tackled the underlying question of the proper meaning of the term "public."

For example, in the wake of a series of corporate scandals involving prominent publicly traded companies like Enron and WorldCom, Congress approved the Sarbanes-Oxley Act of 2002.[40] That law, informed by the accounting and governance improprieties at some of the nation's largest companies, imposed new reporting and management requirements on public companies and created a new agency, the Public Company Accounting Oversight Board, as an overseer.[41] A few years later, in the wake of a financial crisis that pushed the nation as close as it has come to the Great Depression, Congress acted again, this time approving the Dodd-Frank Wall Street Reform and Consumer Protection Act.[42] Informed by revelations of poor investment oversight and excessive risk-taking by some of the nation's largest companies, the law imposed additional governance requirements on public companies and required additional disclosures.

The more abstract question of when corporate and/or investor conduct should be understood as public unfortunately did not receive attention in the debates over either of these laws, which addressed specific, perceived shortcomings in the pre-crisis financial regulatory regime. As Professor Hillary A. Sale has observed, these laws represented incursions into previously unregulated aspects of corporate conduct not on a systematic basis and not as a result of a comprehensive analysis of the rationale underlying the federal role in financial markets, but rather because private actors failed in concrete and spectacular fashion to regulate specific aspects of their business or investment practices themselves.[43]

B. *Aspects of Publicness*

To be public has a much broader meaning in other contexts beyond financial regulation. The United States is a republic, a form whose name derives from the Latin phrase *res publica*, translated in its simplest terms as the "public thing."[44] Public connotes service to the community, perhaps to society at large, as well as community ownership and responsibility for

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[40] Pub. L. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

[41] 15 U.S.C. § 7211(a) (2012).

[42] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

[43] Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1022 (2013).

[44] Definition of "Res Publica", MERRIAM-WEBSTER UNABRIDGED DICTIONARY, http://www.merriam-webster.com/dictionary/republic [http://perma.cc/942S-2TAX] (last visited Sept. 14, 2015).

whatever is public. Politicians speak of a "public trust,"[45] students assert an interest in "public service," and government entities, like municipal agencies responsible for the quality of streets or provision of subsidized housing, have titles that include the term.[46] Thus to be public has particular meanings that reflect the use that the public thing serves. A public good, as an economist would define it, is one that benefits the community. It is this meaning of publicness, which captures the impact of corporate conduct on the community, that corporate and securities law scholars like Professor Sale,[47] Donald E. Langevoort and Robert Thompson,[48] and Lisa M. Fairfax,[49] among others,[50] have pondered lately in various ways.

Interest in the potential public purposes of corporations has not been limited to the academy, however. The legislatures of several states have recently adopted laws making it possible for corporations, designated "benefit corporations,"[51] to serve a public mission alongside the traditional goal of generating profits to benefit investors.[52] These legislative developments in turn have drawn scholarly attention,[53] although those writing on new legislation have not yet gone so far as to explore the public effects of conduct by private companies.

The possibility of explicitly serving multiple constituencies created by new state laws opens up intriguing and difficult questions about how managers and directors of for-profit entities should weigh the impacts of corporate decisions on parties who are not investors.[54] Efforts to answer

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[45] *See, e.g.*, Press Release, The White House, Remarks by the President on Procurement (Mar. 4, 2009), http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Procurement-3/4/09/ [http://perma.cc/2VL2-P5RD] (describing a "fundamental public trust that we must uphold" by reforming federal government contracting procedures).

[46] For example, the City of Cambridge is served by the Department of Public Works, responsible for services including collection of recycling and trash. *See* CAMBRIDGE DEP'T PUB. WORKS, http://www.cambridgema.gov/TheWorks/ [http://perma.cc/P9V3-983R] (last visited Sept. 9, 2015).

[47] *See* Sale, *supra* note 43 (analyzing limits imposed by Congress on public company corporate governance).

[48] *See* Langevoort & Thompson, *supra* note 29 (discussing a framework for classifying public companies).

[49] *See* Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 414–24 (2002) (analyzing the implications and effects of conversions of previously publicly operated entities like hospitals and primary and secondary schools into private, for-profit corporations).

[50] For example, the concept of "publicness" was the subject of an extended discussion at a roundtable at the Southeastern Association of Law Schools annual meeting in 2014.

[51] For illustration, this is the designation used in California. CAL. CORP. CODE § 14610 (West 2015).

[52] Alicia E. Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In?*, 14 U.C. DAVIS BUS. L.J. 247, 249 (2014).

[53] *See, e.g.*, Fairfax, *supra* note 49, at 426–30 (evaluating potential objections to corporate directors' pursuit of goals beyond shareholder wealth maximization).

[54] *Id.* at 440–42.

such questions should force a discussion of what the possible effects of corporate and/or investment conduct are, and hopefully of proper methods of evaluating and responding to those effects. The "public" effects of business activities must be identified in order to determine where the costs of any social harms should be allocated. For example, if a company pollutes the environment, the cost must be recognized before it can be assigned or reassigned.[55] Similarly, if investment decisions have public effects, the costs of bad decisions must be recognized before they can be assigned or reassigned, or ideally, before policies can be adopted to reduce their likelihood in the first place.[56]

Business and securities law scholars writing about publicness have generally not allowed the term to encompass so much. Rather, scholars including Professors Langevoort and Thompson have focused on the proper determination of when a company should be classified as public, meaning that the corporation should be subject to the greater disclosure requirements imposed by federal law.[57] Policy and technology changes that permit companies to access capital without offering shares through a public offering make efforts to police the border between public and private, as the terms have been used in the securities law context, more difficult and perhaps less relevant. At the same time, the traditional regulatory regime classifying companies does not distinguish on the basis of "societal footprint"[58]—a concept that is consistent with the much broader notion of what it means to be public, that this Article argues for, and that Professors Langevoort and Thompson treat as relevant to the determination of when greater disclosure requirements should be imposed.[59]

Others have characterized greater regulation of corporate conduct as extending the reach of the regulatory regime applicable to companies. In this view, greater publicness is the analogue of privatization: when corporate decision-making is subject to greater regulatory and legislative constraints, the shift constitutes an extension of public power into a

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[55] *See* Jeffrey L. Dunoff, *From Green to Global: Toward the Transformation of International Environmental Law*, 19 HARV. ENVTL. L. REV. 241, 258 (1995) (discussing analysis of the failure to impose costs of environmental harm on consumers and producers in order to reduce such harm).

[56] *See, e.g.*, David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2168–69 (2014) (arguing that fiduciary duties of officers and directors, properly understood, should preclude pension funds from making investments that could lead to loss of beneficiaries' jobs).

[57] Langevoort & Thompson, *supra* note 29, at 341.

[58] *Id.* at 342.

[59] This Article, in contrast, argues that what Professors Langevoort and Thompson might view as the societal footprint should both encompass the purpose for which a private entity acts and potentially justify the imposition of constraints on that entity's conduct. The requirements this Article suggests could be imposed on institutional investors, for example, go well beyond imposition of reporting requirements under the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

previously private sphere.[60] The removal of officer and director discretion by legislative fiat was the response to scandals involving corporate conduct, after the financial accounting scandals in 2001–2002: Congress imposed requirements on public company boards, mandating that members of the auditing committee be independent, for example.[61] After the financial crisis of 2008, lawmakers imposed the requirement that companies seize, or claw back, payments made to executives on the basis of corporate financial performance based on spurious data.[62] In each case, the government removed corporate officers' and directors' discretion.

Scholars who have focused on corporate governance have addressed the question of the extent to which stakeholders other than shareholders should weigh in on decision-making by corporate officers and directors.[63] Professor Lynn A. Stout has persuasively argued that one rationale for the power of corporate boards relative to shareholders is enabling the corporation to serve multiple constituencies, beyond holders of its stock, in order to serve best the needs of the entity.[64] Professor Stout argues that more than investment by shareholders is necessary to make a corporation succeed, noting that creditors must have faith in corporate decision-making, as must employees, vendors, and customers.[65] Shareholders in myopic pursuit of short-run profit might well indulge in choices that would disserve necessary constituencies. From a broader perspective, shareholders might oppose—and in one venerable and widely taught case, they did oppose—corporate philanthropy.[66] Acknowledging that the interests of various public corporation stakeholders should be weighed when evaluating corporate governance regimes is only a small step from acknowledging that achievement of public missions should also factor in analysis and regulation of corporate conduct.

Professor Lisa M. Fairfax addresses precisely the question of the authority of corporate directors to act on the basis of concerns about constituents other than shareholders, and concludes that corporate law does

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[60] *See* Sale, *supra* note 43, at 1019 (distinguishing between the indirect government influence of the past and the mandatory duties and decision-making responsibilities imposed on corporate officers and directors by the Sarbanes-Oxley Act).

[61] *See* 15 U.S.C. § 7201 (2012).

[62] *See* 15 U.S.C. § 78j-4 (2012).

[63] *See, e.g.*, Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 668–69 (2002); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PENN. L. REV. 667, 680–81 (2003).

[64] Stout, *supra* note 63, at 680.

[65] *See id*. at 680–84 (developing an example of how corporate stakeholders other than shareholders might behave in the presence and absence of constraints on shareholder conduct).

[66] *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 590 (N.J. 1953) (holding that a shareholder could not challenge a philanthropic donation by corporation to Princeton University).

afford them the flexibility to do so.[67] Her analysis may assuage critics philosophically opposed to privatization, who argue that the public mission of privatized businesses will be compromised by the pursuit of profit.[68] While Professor Fairfax's question of whether profit maximization can be consistent with achievement of public goals is related to the argument of this Article, her focus was on the possibility that the interests of shareholders and the public might diverge.[69] This Article is motivated by concern that institutional investors serving public goals might make mistakes.

There are profound ramifications to recognition that ostensibly for-profit legal entities like corporations can and do serve missions properly conceived of as public.[70] This Article of necessity seeks only to highlight the challenge created by the continued blurring of the line dividing public from private. The discussion that follows analyzes the implications and offers a policy response in just one area, involving the availability of the private offering exemption to disclosure requirements imposed by federal law on public offerings of securities. But the focus of the Article is not meant to suggest that the implications of adopting a broader definition of publicness do not extend much further.

III. PRIVATE OFFERINGS: THE FRAMEWORK AND ITS PROBLEMS

The federal securities laws adopted in the wake of the market crash of 1929 focused primarily on the protection of investors. However, lawmakers and, subsequently, courts have long accepted that not all investors are equally in need of assistance.[71] Certain investors, those perceived as having the ability to protect themselves, may purchase securities that have not been registered with the Securities and Exchange Commission (SEC); the registration requirement is deemed unnecessary. This exemption regime, classifying investors based on wealth, limits participation in potentially riskier transactions only to the extent that the presumption that investor wealth correlates with sophistication holds true.[72]

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[67] *See* Fairfax, *supra* note 49, at 473–74 (concluding that because the flexibility and permissiveness of corporate law allows directors the freedom to pursue the interests of non-shareholders, the social entity conception of the corporation has taken precedence over the shareholder primacy model).

[68] *See id*. at 428 & n.93.

[69] *See id*. at 429–30.

[70] For example, insurance companies, whose policies benefit third parties, invest in order to help fund their operations. To the extent that the availability of policies to beneficiaries is a public goal, enhanced regulation of insurer investment activity could be consistent with the arguments made in this Article about public pension funds. However, such a proposal is beyond this Article's scope.

[71] SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[72] The problem of the unsophisticated but wealthy person is addressed in colorful fashion in a student note describing, among other things, how the regulations would treat the heiress Paris Hilton.

This Part summarizes the different exceptions to the general requirement that securities be registered, analyzes criticisms of the exemption regime, and explains why its shortcomings matter.

A. *When Securities Need Not Be Registered*

Section 5 of the Securities Act prohibits sale of a security unless that security is registered with the SEC.[73] However, issuers may sell securities that have not been registered pursuant to one of several possible exemptions, or "safe harbors." Private offerings typically take advantage of exemptions described in Section 4(2) of the Securities Act, the rules under Regulation D (the most important of which draws its authority from Section 4(2)),[74] Rule 144A,[75] and Regulation S.[76] Each exemption regime is described in brief below.

1. *Section 4(2) of the Securities Act*

Section 4(2) of the Securities Act exempts from the registration requirement of Section 5 any transaction "by an issuer not involving any public offering."[77] Thus, an issuer can sell an unregistered security to a buyer, so long as the sale does not constitute a public offering. The Supreme Court has reasoned that if the rationale for the Securities Act's registration requirement generally is "protect[ion] of investors by promoting full disclosure of information thought necessary to informed investment decisions," then the "natural" justification of the exemption is that the participants are investors "who are shown to be able to fend for themselves."[78]

Lower courts attempting to discern whether a securities transaction constitutes a public offering have focused on aspects of the offering including the number of offerees, their relationship to each other and the issuer, the number of units (such as shares) offered, the manner in which they were offered, and the sophistication of the offerees.[79] The more people to whom the security is offered, the greater the number of securities sold,

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Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 733 (2009).

[73] Securities Act of 1933, ch. 38, § 5(a), 48 Stat. 74, 77 (codified as amended at 15 U.S.C. § 77e (2012)).

[74] *Id.* § 4(2), 48 Stat. at 77.

[75] 17 C.F.R. § 230.144A (2014).

[76] *Id.* §§ 230.901–.905.

[77] Securities Act of 1933 § 4(2), 48 Stat. at 77.

[78] SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953). Interestingly, in this oft-quoted case, the Court implied that an evaluation of a potential purchaser's need for protection turned not on characteristics of that investor, but on the nature of the information provided by the seller. *Id*. at 127.

[79] SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980); *see also* Doran v. Petrol. Mgmt. Corp., 545 F.2d 893, 905 (5th Cir. 1977) (applying a slightly different set of factors).

the more broadly accessible the transaction is (i.e., the more widely distributed the issuer-disseminated information about the transaction), and the less sophisticated the potential purchasers, the more likely the transaction is to be deemed public and consequently not eligible for the exemption. Cases generally do not, however, explore the rationale for presumption of sophistication in more detail than the Supreme Court did initially, nor do they ponder whether there are other reasons beyond the statutory text to permit or deny an investor from participating in a private offering.

2. *Regulation D: Rules 504, 505, and 506*

Regulation D, through three implementing rules, provides other often-used paths around registration. Rule 504, which draws on authority granted by Section 3 of the Securities Act,[80] exempts sales of securities by issuers offering and selling securities worth no more than $1 million in a twelve-month period.[81] Rule 505, which also draws on Section 3, exempts sales of securities provided that the aggregate offering price does not exceed $5 million.[82] Rule 506, which draws its authority from Section 4(2) of the Securities Act,[83] imposes no limit on the amount of money that can be raised through a private offering, but does limit the offering to "accredited investors" and no more than thirty-five sophisticated investors that are not accredited.[84] Because it does not include a dollar limit, Rule 506 is particularly appealing to issuers.

The exemptions do not mean that issuers are free of any obligation to provide information to any prospective investor. In fact, issuers are required to provide information like that required in a registration statement, with a level of detail that increases as the value of the offering rises, to investors that are not accredited.[85] The securities sold through any of these safe harbors are "restricted," meaning that resale by the purchaser is prohibited unless the security is registered or the subsequent transaction is independently exempt from registration requirements.[86]

Accredited investors, according to Section 3(a) of the Securities Act,

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[80] Section 3(b) permits the SEC to use its regulatory power to add to the Act's list of exempt securities "by reason of the small amount involved or the limited character of the public offering." However, no issue may be exempt if the aggregate amount of securities offered is greater than $5 million. *Id*.

[81] 17 C.F.R. § 230.504 (2014). The exemption is limited to issuers that are not subject to reporting requirements of the Securities Exchange Act of 1934, that are not investment companies, and that are not "development stage compan[ies]" that do not have a specific business plan or that have a business plan "to engage in a merger or acquisition with an unidentified company or companies." *Id.*

[82] *Id.* § 230.505.

[83] *See supra* Part III.A.1 (discussing the scope of Section 4(2)).

[84] 17 C.F.R. § 230.506 (2014).

[85] *Id.* § 230.502(b).

[86] *See infra* Part III.A.3 (describing regulations limiting resale of unregistered securities).

include banks, savings and loan associations, investment companies, executives of the issuer, individuals whose net worth exceeds $1 million or whose income exceeded $200,000 in each of the two most recent years, or trusts and state benefit plans with assets of more than $5 million.[87] A sophisticated investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[88] These clear and concrete criteria have the benefit of easy administration, but presume a correlation between ability and wealth.

Sellers serving these accredited and/or sophisticated investors avoid a regulatory burden; buyers in turn are expected to be sufficiently savvy to ask for disclosure of the information they deem relevant to making their investment decision. Use of quantifiable investor characteristics has the advantage of simple application, because determining wealth or corporate form is relatively straightforward, but this Article argues that these criteria are not up to the task.

3. *Rules 144 and 144A*

The above exemptions apply to initial offerings of securities made by an issuer to buyers participating in a private offering.[89] Separate restrictions and exemptions apply to resale of securities initially purchased by accredited or sophisticated investors.[90] This complementary regime prevents initial purchasers from serving as conduits for the sale of securities on public secondary markets, such as stock exchanges. Under Rule 144, securities acquired in a transaction that did not involve a public offering may not be resold for six months if the issuer is a publicly traded company and for one year if the issuer is not a publicly traded company.[91] Even after this holding period has expired, such "restricted securities"[92] may not be sold to the general public unless specific, additional

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[87] 17 C.F.R. § 230.501(a) (2014). The list above is not exhaustive. In calculating the net worth of an individual investor, the rule requires exclusion of the value of that individual's residence. *Id.* § 230.501(a)(5).

[88] *Id.* § 230.506(b)(ii).

[89] *Id.* § 230.506(a).

[90] *Id.* § 230.144A(d)(1).

[91] *Id.* § 230.144(d)(1). The shorter restriction applies if the issuer has been subject to the periodic reporting requirements of the Exchange Act for at least ninety days prior to the initial sale; the longer restriction applies if the issuer has *not* been subject to the reporting requirements for at least ninety days prior to the sale. *Id.* The intuition is, if the issuer discloses financial information in its periodic reports, then the potential buyer of the restricted securities is more likely to be able to evaluate the value and riskiness of the securities.

[92] *Id.* § 230.144(a)(3).

requirements have been met.[93]

Rule 144A provides an exemption for sales of restricted securities "acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering."[94] The holder of such securities may sell to a "qualified institutional buyer" (QIB), a category which is not the same as an accredited investor.[95] QIBs include insurance companies, investment companies, and employee benefit plans, provided that the entity "owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity."[96] Because of this asset requirement, QIBs invariably are accredited investors, but the converse is not true.

Like the standards applicable to accredited investors, the QIB requirements are easy to apply, focused as they are on a relatively straightforward valuation of an institutional investor's assets. The QIB requirements differ in that a presumption of sophistication based on control of $100 million of securities may seem safer than a presumption based on the wealth thresholds applicable to accredited investors; the QIB requirement is more likely to narrow the field to investors that have significant investment experience.[97]

In the wake of the financial crisis of 2008, the SEC modified Rule 506 and Rule 144A in 2013 to implement a provision of legislation intended to bolster economic growth.[98] The changes permit an issuer of securities through a private placement or a seller of securities purchased through a private placement, respectively, to engage in general advertising and general solicitation of potential purchasers, provided that purchasers are accredited investors and that the other requirements of the rule are met.[99] The amendment did not change the method of classifying investors as "accredited," nor did it include criteria for determining definitively whether a non-accredited investor was sufficiently sophisticated to participate. However, the amendment did provide guidance to issuers or sellers trying to take advantage of the safe harbor, to help avoid reaching

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[93] *Rule 144: Selling Restricted and Control Securities*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/investor/pubs/rule144.htm [http://perma.cc/HK4F-JNXJ] (last visited Nov. 29, 2015).

[94] 17 C.F.R. § 230.144(a)(3).

[95] *Id.* § 230.144A.

[96] *Id.* § 230.144A(a)(i). This list is a subset, not a comprehensive list, of the entities that qualify as QIBs.

[97] The rationale behind the $100 million requirement, as opposed to $50 million, for example, is unclear. Either way, the requirement clearly would exclude far more investors than the accredited investor criteria do.

[98] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012) (mandating SEC action).

[99] 17 C.F.R. §§ 230.506(c)(2)(ii), 230.144A(d)(1) (2014).

an erroneous conclusion that a purchaser was accredited.[100] These criteria are relevant for this Article because they describe various ways that a seller can safely evaluate buyer sophistication.

The amended rule suggests that an issuer seeking to verify that a potential purchaser is an accredited investor consult Internal Revenue Service forms showing income,[101] bank statements, reports of credit rating agencies, or written statements from brokers, investment advisers, lawyers, or accountants who have worked with the investor.[102] Unfortunately, these criteria[103] do not signal a shift away from simple, mechanical tests measuring easily observable investor characteristics that may be unreliable proxies for sophistication. The amended rule still relies on measures of net worth, rather than some evaluation of investor experience, skill, or resilience, as advocated in this Article. This persistent reliance on assets as an indicator of ability represents a dangerous continuation of an outdated mode of thinking about investors, as demonstrated in Part IV below.

4. *Regulation S: Rules 901–905*

Under Regulation S, offerings and sales of securities outside the United States are not subject to the registration requirements of Section 5 of the Securities Act.[104] The rule provides safe harbors for offers and sales of securities in specific transactions, all subject to two general conditions: (1) the offer and sale must occur in an "offshore transaction,"[105] meaning that either the seller believes the buyer is offshore when the sale is consummated, or that the sale takes place on one of several, specifically identified offshore exchanges; and (2) the offer and sale are not the subject of "directed selling efforts," defined as "any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on . . . Regulation S."[106] In this context, "conditioning the market" refers to efforts to drum up interest in the offering and sales opportunity by, for example, mailing materials to potential investors.[107]

Because the eligibility for this exemption from the registration

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[100] *Id.*

[101] The issuer is also advised to procure a statement from the purchaser indicating that the purchaser anticipates future income sufficient to qualify as an accredited investor in the current year. *Id.* § 230.506(c)(2)(ii)(A).

[102] *Id.* § 230.506(c)(2)(ii)(B)–(C).

[103] The SEC is careful not to require consideration of any or all of the factors listed in the amended rule; the methods listed "are examples of the types of non-exclusive and non-mandatory methods that satisfy the verification requirement." *Id.* § 230.506(c)(2)(ii)(D).

[104] *Id.* § 230.901.

[105] *Id.* § 230.903(a)(1).

[106] *Id.* § 230.902(c).

[107] LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 221–23 (5th ed. 2004).

requirements of the Securities Act does not turn on investor characteristics but on geography, this Article will not spend more time evaluating it.

B. *Concerns over Private Offerings*

Private offerings represent a fast-growing share of securities offerings. In recent years, the amount of capital raised by private offerings of securities has exceeded the amount raised through public offerings: in 2010, according to one study, offerings of public company stock raised slightly more than $200 billion, while the value of securities sold through private offerings was about four times greater.[108] The bulk of losses suffered by pension funds in the wake of the financial crisis were the result of declines in stock prices,[109] but securities purchased in private offerings resulted in hundreds of millions of dollars in losses, including losses to public pension funds estimated at one point to exceed 25% of total assets between 2007 and early 2009.[110] Blame for the declines in asset values cannot be laid entirely or even mostly on investments in "alternative investments" including hedge funds and private equity. But one report estimated that these investments accounted for 7% of total assets in a typical pension portfolio, so they do bear some responsibility.[111] From October 2007 through March 2009, declines in the value of these investments accounted for a decline in total asset value of slightly less than 2%.[112] In contrast, declines in stock prices, bonds, and loans, which combined accounted for 85% of the typical pension portfolio, resulted in a 34% decline in asset value.[113] Improving financial markets in subsequent years may have helped pension funds recover some of that asset value, but that is not the end of the issue; pension funds need not only to avoid losses but also to grow in order to keep up with rising costs.[114] Consequently, the shortcomings of the exemption regime matter and will matter more as pension funds purchase more of these alternative investments. This Part provides a critique of that regime.

Investor decisions in the years leading up to the financial crisis of

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[108] U.S. SEC. & EXCHANGE COMM'N, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION 3 fig.3 (2012), http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf [http://perma.cc/2X6N-5RCN].

[109] DOUGLAS J. ELLIOTT, BROOKINGS INST., THE FINANCIAL CRISIS' EFFECTS ON THE ALTERNATIVES FOR PUBLIC PENSIONS 2 (2010), http://www.brookings.edu/~/media/research/files/papers/2010/4/20-public-pensions-elliott/0420_public_pensions_elliott.pdf [http://perma.cc/8GRU-GWX2].

[110] *Id.* at 1.

[111] *Id.* at 2 tbl.1.

[112] *Id.*

[113] *Id.*

[114] *Id.* at 2 ("The public pension funds may have lost 15% over two years on a 'nominal' basis, but, if their target return was 8% a year, they lost 31% compared to their targeted level of investment value, excluding the effects of contributions and pension payments." (footnote omitted)).

2008[115] call into question the presumption that wealth correlates with sophistication.[116] Sizable institutional investors often purchased securities in private offerings and in many cases did not take appropriate or adequate steps to protect themselves.[117] Indeed, the crisis revealed just how many institutions previously considered astute navigators of financial markets were in fact capable of remarkably poor judgments.[118] According to the report of the commission tasked by Congress with identifying the causes of the crisis, purchasers of doomed mortgage-linked securities[119] who were "qualified institutional buyer[s]" under SEC rules[120] "included investors as diverse as insurance companies like MetLife, pension funds like the

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[115] Investor decisions a decade earlier, during the technology bubble that led into the new millennium, also raise questions.

[116] Government investigations into investments by public pension funds in alternative investments have found shortcomings in institutions' procedures and recommended that the government provide guidance for future transactions with private equity and hedge funds. U.S. GOV'T ACCOUNTABILITY OFFICE, DEFINED BENEFIT PENSION PLANS: RECENT DEVELOPMENTS HIGHLIGHT CHALLENGES OF HEDGE FUND AND PRIVATE EQUITY INVESTING 9, 15–17 (2012), http://www.gao.gov/assets/590/588623.pdf [http://perma.cc/5VX2-BGUA] (finding that while most of the fund executives interviewed expressed satisfaction with the performance of their alternative investments, they also described challenges in the form of illiquid investments, limited transparency, and adverse effects of co-investors' withdrawals). Public pension funds with tens of millions of dollars to invest may suffer losses on transactions into which they were enticed by misconduct, as well. *See, e.g.*, *SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds*, U.S. SEC. & EXCHANGE COMM'N (Jan. 30, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540703682#.VMKxg8aOKgc [http://perma.cc/8ESR-W5RU] (describing the SEC's complaint against a private equity fund manager who essentially used for improper purposes funds invested by pensions and other investors); *SEC Charges Private Equity Firm and Money Manager for Defrauding Detroit-Area Public Pension Funds*, U.S. SEC. & EXCHANGE COMM'N (Apr. 23, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21500.htm [http://perma.cc/4JL6-NHT8] (describing a complaint by the SEC that alleged deception of three public pension funds in Michigan).

[117] The Financial Crisis Inquiry Commission, created by Congress to look into the causes of the financial crisis that began in 2008, concluded that "financial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective." NAT'L COMM'N ON THE CAUSES OF THE FIN. & ECON. CRISIS IN THE U.S., THE FINANCIAL CRISIS INQUIRY REPORT xvii (2011) [hereinafter FCIC REPORT], http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [http://perma.cc/CTK8-XA9X].

[118] *See* Langevoort & Thompson, *supra* note 29, at 362–63 (examining how institutional buyers willingly purchased so much risk).

[119] FCIC REPORT, *supra* note 117, at 169–70. Specifically at issue were collateralized debt obligations, or CDOs, which are securities whose value depends on the performance of a bundle of home loans.

[120] While Regulation D applied to sales of securities by the issuer, sales of collateralized debt obligations implicated in the financial crisis often were subject to Rule 144A. *Id.* at 170. This regulation permits sales of certain securities to "qualified institutional buyers." *Id.* Various types of entities, such as investment companies, insurance companies, small business investment companies, employee benefit plans, and trust funds, can be QIBs, provided that they "in the aggregate own[] and invest[] on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the [investing] entity." 17 C.F.R. § 230.144A(a)(1)(i) (2014). Rule 144A applies to resale of existing securities. FCIC REPORT, *supra* note 117, at 170. The advantage of 144A transactions is exemption from SEC registration requirements; these transactions were not considered public offerings. *Id.*

California State Teachers' Retirement System, and investment banks like Goldman Sachs."[121]

Even municipalities with tens of millions of dollars to invest might not properly investigate a transaction before entering it.[122] Financial companies, despite decades of experience selling insurance against all manner of catastrophes, might fail to prepare for the possibility that they might have to pay on guarantees of complex financial transactions.[123] Companies whose job it is to evaluate the worth of complex securities might fail, for whatever reason, to do so.[124] The failure to study an investment adequately ahead of time may have been the result either of an influx of investors inexperienced in the world of asset-backed securities, of weak incentives to avoid risk, or of inadequate internal controls within investing institutions. Whatever the cause, the result was investment in securities tied in various ways to real-estate debt by buyers whose wealth suggested sophistication but whose conduct revealed a dangerous combination of arrogance, greed, recklessness, and, above all, naiveté.[125]

If investors that meet the regulatory requirements do not in fact have the capacity to evaluate the riskiness of transactions ahead of time or the resources to withstand losses if adverse risks materialize, then the exemption regime is not an effective screening device. The current structure, based on eighty-five-year-old beliefs about investor sophistication and wealth, does not take into account what history has made evident: investors who satisfy the criteria often do not deserve the presumption.[126] The exemption regime does not screen institutions that, though they manage large amounts of money, may not be sophisticated. Nor does the regulatory regime effectively screen investors that do not take advantage of their capacity to evaluate a deal even though they have it.

Scholars have begun to investigate how investment decisions are made in an institutional setting, in part to understand how mistakes happen. They have identified factors, from compensation structures to group dynamics to

[121] FCIC REPORT, *supra* note 117, at 170 (footnote omitted).

[122] *E.g.*, Terra Sec. ASA Konkursbo v. Citigroup, Inc., 740 F. Supp. 2d 441, 443–44 (S.D.N.Y. 2010) (illustrating one example of insufficient pre-investment research in a case in which Norwegian municipalities alleged common-law fraud and violations of federal securities laws after investing disastrously in notes sold by the defendants).

[123] *E.g.*, FCIC REPORT, *supra* note 117, at 140–41 (outlining a lead example of this lack of preparation in AIG's credit default swap business prior to the 2008 crisis).

[124] *Id.* at 212.

[125] *Id.* at xvii.

[126] Given the relatively small amount of money an individual must have in order to qualify as an accredited investor, it is correspondingly likely that an individual investor that barely satisfies the requirement lacks the resources to perform due diligence on a complex securities transaction. The less wealthy an individual investor, of course, the more likely that investor is to invest through an intermediary, and the less likely it is that the investor would be approached by a seller offering a complex security through private offering.

heuristics relied upon by individual executives, that may get in the way of sophisticated conduct.[127] Institutions, like individuals, are subject to pressures and biases that may result in poor investment decisions and/or poor implementation of investment decisions. Institutions may not conduct thorough due diligence on securities, for example, when executives leading them are motivated by a desire to keep up with rivals buying the same instruments. These findings matter because institutional investors have come to dominate securities markets;[128] fewer individual investors purchase securities directly at the retail level.[129]

The regulatory regime that classifies investors as sophisticated also fails to take into account the increasingly complex securities bought and sold on financial markets. Transactions have become harder to classify, with private offerings that function like public offerings[130]and public company stock sales that look like private placements.[131] As financial instruments have become more intricate, understanding their structure and potential effects has grown more difficult; sellers of securities implicated in the financial crisis of 2008 commented dismissively time and again on the ability of purchasers to figure out what they were buying.[132] Yet the regulations defining accredited investors do not take into account the difficulty of understanding the consequences of a particular investment and do not, for example, specify some level of expertise buyers must demonstrate, let alone require them to weigh the potential effects of poor decisions.

Institutional relationships are also increasingly complex, with intermediaries investing in private offerings directly, or in hedge funds or

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[127] *See* Steven M. Davidoff & Caire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 610 (2013); Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 818 (2010).

[128] Luis A. Aguilar, Comm'r, U.S. Sec. & Exchange Comm'n, Institutional Investors: Power and Responsibility, Remarks at Georgia State University (Apr. 19, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1365171515808 [http://perma.cc/FFN6-AKW2] ("[T]he proportion of U.S. public equities managed by institutions has risen steadily over the past six decades, from about 7 or 8% of market capitalization in 1950, to about 67% in 2010.").

[129] Davidoff, *supra* note 22, at 340 (identifying "the trend of investment intermediation and deretailization" as a significant development in the new capital market).

[130] For example, Goldman Sachs' pre-public-offering investment of $500 million in Facebook. Susanne Craig & Andrew Ross Sorkin, *Goldman Offering Clients a Chance to Invest in Facebook*, N.Y. TIMES (Jan. 2, 2011, 12:42 PM), http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/.

[131] *See generally* Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 220 (2009).

[132] *E.g.*, Dodona I, LLC v. Goldman, Sachs & Co., 847 F. Supp. 2d 624, 642 (S.D.N.Y. 2012) (describing an e-mail in which a Goldman-Sachs' employee laments a client's ability to understand a transaction); FCIC REPORT, *supra* note 117, at 235–36 (describing efforts by a Goldman Sachs' vice president to encourage sales of securities to buyers other than "sophisticated hedge funds").

private equity funds on behalf of retail savers, such as workers trying to prepare for retirement.[133] Such investment patterns make regulating investor conduct more difficult; investors can do indirectly what they cannot do directly. Prohibitions in such a market will not prevent misconduct, they will simply force innovation.[134] These relationships among institutions, for example between pension funds and hedge funds in which they invest,[135] also serve to blur the distinction between entities classified as public for securities law purposes and those classified as private.[136] Hedge funds and private equity funds are major players on public exchanges and, more importantly for this Article, institutions serving the unsophisticated public increasingly invest in private offerings and in hedge funds and private equity funds that invest in private offerings.[137] Private offerings by definition do not face the same disclosure requirements as public offerings, thereby limiting the SEC's ability to monitor.

Nor does the exemption regime take into account more intangible characteristics that suggest sophistication. There are other ways investors are classified, informally but significantly. The decisions of some investors have powerful effects on financial markets, even if the size of the investment is modest for that investor; when the legendary investor Warren Buffett put $5 billion into Goldman Sachs early in the fall of 2008, his move was reassuring to financial markets.[138] Buffett's influence is certainly related to his wealth, but that alone does not (and should not) account for the respect given him. He is also a longtime investor who has made astute choices over time, and investors who are repeat players, who conduct

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[133] Davidoff, *supra* note 22, at 352.

[134] *See id.* at 355 (pointing out the delay between the comparatively slow regulatory process' response to investors' adaptation to new regulations).

[135] The nation's largest public pension funds hold slightly more than fifteen percent of their assets in "alternative" investments that primarily consist of private equity and hedge funds. *Summary of Findings for FY 2013*, PUB. FUND SURV. (Jan. 2015), http://www.publicfundsurvey.org/publicfund survey/summaryoffindings.html [http://perma.cc/F99X-GVS8]. The Public Fund Survey reflects data on state and local government retirement systems overseeing $2.86 trillion. *Id.* Public pension funds hold more than $4 trillion in assets. Luis A. Aguilar, Comm'r, U.S. Sec. & Exchange Comm'n, Evaluating Pension Fund Investments Through the Lens of Good Corporate Governance, Remarks at the Hispanic Heritage Foundation's Latinos on Fast Track Investors Forum (June 27, 2014), http:// www.sec.gov/News/Speech/Detail/Speech/1370542193403#_edn1 [http://perma.cc/8DTW-86Z5].

[136] Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 76 (2012).

[137] *See supra* note 135 (describing the extent of public pension fund investment in alternative investments, including private equity and hedge funds); *see also* Steve Eder et al., *Pensions Leap Back to Hedge Funds*, WALL ST. J. (May 27, 2011), http://www.wsj.com/articles/SB1000142405270230365 4804576347762838825864 (reporting on public pension funds' shift to private equity and hedge fund investments a few years after the 2008 financial crisis).

[138] *See* Andew Bary, *Warren Buffett Makes an Offer Goldman Sachs Can't Refuse*, WALL ST. J. (Sept. 28, 2008), http://www.wsj.com/articles/SB122256922970483051.

similar transactions repeatedly, have more expertise than those whose transactions are more sporadic or varied. The more prestige, for want of a better word, the investor amasses and the longer that investor's track record of success, the more likely it is that the investor has access to transactions unavailable to other market participants. Of course, prestige presents certain challenges to quantification.

Courts have at times noted the significance of the quality of advisers to investors. Large investors entering significant and complex transactions retain Wall Street law firms to counsel them on legal risks of a transaction, investment bankers to help structure and finance it, accounting firms to help verify asset values, and possibly even media advisers to shape the appearance of a deal to other investors, the news media, lawmakers, and regulators.[139] One proposed reform would impose on broker-dealers stronger obligations to evaluate how appropriate an investment, including a private offering, would be in the context of the buyer's current portfolio, thereby putting on the broker-dealer the burden of deciding whether a transaction is suitable for that investor.[140] A now-classic article describing courts' inconsistent evaluations of investor sophistication offers a theoretical framework for determining when sophistication should matter, and provides a list of investor characteristics that should figure in courts' evaluations.[141]

In a provocative article, Professor Stephen Choi proposes using a test to sort investors more directly.[142] The test would require a would-be investor to demonstrate knowledge of the "function of different market participants, the risks they pose, and available investor protections."[143] Performance on the test would enable an investor to participate in

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[139] Given their financial resources, such investors are likely to have access to sophisticated representation, should they choose to pursue recovery through litigation when a transaction is unsatisfactory. *See* Vijay Sekhon, *Can the Rich Fend for Themselves?: Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010*, 7 HASTINGS BUS. L.J. 1, 7–8 (2011).

[140] Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 314 (1994). The underlying concern expressed in the article is the risk of fraud against wealthy, unsophisticated individual investors, rather than the systemic risk posed by wealthy, unsophisticated financial entities. *Id.* at 317.

[141] *See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1137–47 (1988) (describing five principles that should guide courts deciding when to take into account investor sophistication); *id.* at 1149–54 (providing an appendix listing investor characteristics potentially relevant to the assessment of sophistication). The list includes pragmatic and direct criteria such as investment experience, professional status, history of speculative investments, government or business experience, professional experience in the securities industry, as well as potentially more subjective criteria, such as education, intelligence, age and, indeed, wealth and income. *Id*.

[142] Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 311 (2000).

[143] *Id*.

transactions subject to more or less mandatory disclosure: the most sophisticated investors could invest in a private offering because such investors would be deemed capable of protecting themselves, while the least sophisticated investors would be limited to investing in intermediary institutions that possessed greater financial expertise.[144] The advantage of such a regime, were it mandatory,[145] is its focus on actual investor knowledge directly, not via a proxy like wealth. The disadvantage is the need to design tests, which take time to develop, and would inevitably be imperfect and could produce false positive and false negative results, as Professor Choi notes.[146] And while a more direct regulatory scheme is appealing, it would not eliminate an investor's incentive to take on excessive risk in pursuit of returns needed to meet its other financial obligations,[147] nor solve the problems of mistake or misconduct.

Even investors with great expertise make mistakes or suffer lapses in judgment, choosing to jump on bandwagons in a doomed caravan, as did buyers of mortgage-linked securities in the years leading up to the 2008 financial crisis.[148] Prior to the crisis, too many investors, even large, putatively sophisticated financial institutions, engaged in transactions, the outcomes of which contributed to systemic risk that undermined their ability to perform their public missions of, for example, funding workers' retirements.[149] These developments, which make concerns about growth in private placements[150] more significant, postdate much[151] of the scholarship analyzing and criticizing the classification regime permitting participation

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[144] *Id*.

[145] Professor Choi considers mandatory, voluntary, and hybrid licensing schemes in his article. *Id*. at 310–19.

[146] *Id*. at 312–13. More recently, the Investor Advisory Committee to the SEC, created by the Dodd-Frank Act, has recommended that the Commission consider adopting a test as one way to screen the sophisticated from the less so. RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE: ACCREDITED INVESTOR DEFINITION 6–7 (2014) [hereinafter RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE], http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf [http://perma.cc/SRW6-JYFJ].

[147] For example, a public pension fund's obligations to pay benefits.

[148] Which, to be clear and to be fair, occurred eight years after the publication of Professor Choi's article. *See* FCIC REPORT, *supra* note 117, at 18 (reporting the sale of $1.3 trillion of mortgage-backed securities from the third-quarter of 2006 to the height of the 2008 financial crisis).

[149] At least one post-crisis article has addressed the treatment of sophisticated investors. *See* Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 76 (2012). Professor Martin argues that "prominent institutions that qualify as sophisticated investors have indirectly exposed retail investors to unregulated investment schemes" because retail investors have entrusted their savings to the institutions and the institutions have in turn invested in private placements. *Id*. Professor Martin calls for greater disclosure by hedge funds, for example, to institutional investors serving retail workers, as well as for consolidation of regulatory agencies. *Id*. at 107–11.

[150] *See supra* note 108 and accompanying text.

[151] *But see supra* note 149.

in private placements.[152]

Developing an effective classification regime to identify investors capable of participating in private placements should be part of any effort to prevent a repeat of the investment patterns that led to the crisis. Even if private offerings are made accessible to more investors, as at least one scholar has proposed,[153] the characteristics of those investors should determine the nature and extent of such access. Some will require greater protection and others less.

Nevertheless, screening alone will not avoid future calamity.[154] Ensuring that those individuals and entities investing in private placements have the true wherewithal to do so—that is, *both* the ability to evaluate the investment beforehand *and* to manage adverse outcomes should they materialize—would reduce risk to the financial system and to financial institutions, as well as to individual workers who rely on institutions[155] to manage their money to fund retirement or education.

Because these transactions take place off exchanges and may involve parties unfamiliar with their counterparties and/or buyers without mastery of the nuances of the transaction, there is room for efficiency enhancement by clarifying the capabilities of participants. Those costs now are borne by buyers that do not have adequate information or ability to analyze and manage information needed to evaluate a transaction, and that allocation may be less than ideal. If buyers know that the counterparties they deal with must meet meaningful and relevant criteria in order to invest in a transaction, that knowledge should reduce costs and facilitate consummation of the deal.[156] Failure to adopt a more sophisticated classification regime preserves the risk that too many investors without appropriate resources will buy into transactions too complex or risky for them to handle, with possible collateral consequences extending well

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[152] *See infra* Part IV.A (discussing improved measures of investor sophistication).

[153] Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3393–94 (2013). Unlike Professor Rodrigues, I view the financial crisis as an indicator that *too many* investors already had—and have—access to private transactions and that such access should be restricted.

[154] As Professor Smith points out in the context of the Bernie Madoff scandal, sophistication alone does not ensure diligence or caution. Felicia Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor"*, 40 U. BALT. L. REV. 215, 255–56 (2010).

[155] For example, public pension funds with increasing frequency invest in private transactions. The California Public Employee Retirement System, CalPERS, invested $32 billion, or about ten percent of its portfolio, in private equity as of June 30, 2014. CALPERS, COMPREHENSIVE ANNUAL FINANCIAL REPORT 28 (2014), https://www.calpers.ca.gov/docs/forms-publications/cafr-2014.pdf [https://perma.cc/LA6U-NW5U]. Some of those private equity entities may in turn invest in publicly traded securities.

[156] This is an important point because tightening the criteria accredited investors must meet may at first sound like a highly paternalistic move. But the goal is not to put a stop to private placements—far from it. The goal is to ensure that these transactions take place among investors with the expertise to participate in them, without creating excess risk to other market participants or the functioning of markets themselves.

beyond the parties involved. In the next Part, this Article offers proposals for reform.

IV. REFORMING THE REGISTRATION EXEMPTION REGIME

The regime that relies on investor wealth to determine who may participate in private offerings has evident flaws, in that it approves such participation by individuals and institutions without adequate means of evaluating risk or coping with adverse outcomes. As suggested by some of the critics whose views were discussed above,[157] wealth and/or income may be poor proxies for ability, resources, or experience. This Part first develops an alternative regime that would attempt to capture investor sophistication directly, rather than indirectly, using other investor characteristics. Then, significantly, this Part contends that even an improved measure of investor ability should be subordinated to consideration of the purpose of the investment, on the theory that some investments are too important to be put at risk because they serve critical, public ends. To illustrate how the proposed policy might work in practice, this Part then returns to the case of SDCERA and illustrates how the proposal would have applied to that public pension fund.

The proposal is an outline only; there are critical points that should be subject to debate. For example, what kind of risk tolerance should institutions with public missions have? Can a federal entity like the SEC impose limits on the investor conduct of state public pension funds, in the context of the U.S. federal structure? This Article seeks to encourage debate over questions like these.

A. *Investor Characteristics that Better Measure "Sophistication"*

A tradeoff exists between classification of investors as sophisticated—or accredited, for that matter—based on wealth and/or income, on the one hand, and on other, less simply quantified characteristics, as it is far easier to collect data on wealth and income. A middle ground, based on trustworthy principles, must exist; Professor Choi's licensing proposal,[158] which could require investors seeking to participate in private offerings to pass a test, offers one model.

While traditional methods of classifying investors may miss differences relevant to distinguishing those that are sophisticated from those that merely have significant assets at their disposal, alternative ways of characterizing market participants exist. As a practical matter, first, investors could be required to demonstrate their expertise in order to participate in transactions subject to fewer disclosure requirements. This

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[157] *See supra* Part III.B.
[158] *See supra* note 142 and accompanying text.

would entail something more than a regulatory presumption in favor of sophistication if an investor has a certain amount of wealth.[159] An investor seeking to participate in a private placement could be required to demonstrate sophistication affirmatively by describing participation in past, similar transactions, for example, or by describing steps taken to protect against losses on the proposed investment.

The SEC could propose a more nuanced definition of "accredited investor," requiring investors to earn the right to be considered sophisticated by providing evidence that they had acted like sophisticated investors in the past.[160] Such a showing could be bolstered in a variety of direct and indirect ways, including describing past transactions, for example, or listing the professional conferences that the institution's executives attend.[161] Financial institutions would not be classified by their size[162] but by their conduct—adopting a version of Aristotle's observation that we are what we repeatedly do.[163] Over time, a track record of effective management of the riskiness of particular transaction types in private offerings could result in access to more and larger such investments.[164] One consequence might be that fewer institutional investors would purchase complex securities that are difficult to evaluate. With the benefit of hindsight, such caution appears to be a good thing, although to executives at financial institutions going forward, such a regulatory move would be undesirable.[165]

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[159] *See supra* note 87 and accompanying text.

[160] Existing legislation gives the SEC the authority to define who is an "accredited investor," to whom an issuer may sell an unregistered security. *See* 15 U.S.C. § 77b(a)(15) (2012) ("The term 'accredited investor' shall mean . . . any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the [Securities and Exchange] Commission shall prescribe.").

[161] This would adapt some of the criteria identified by Professor Fletcher for application to institutions rather than individuals. *See supra* note 141.

[162] *See supra* Part III.A (describing the classification of investing institutions under regulations implementing the Securities Act).

[163] Aristotle, *Nicomachean Ethics*, *in* 2 THE COMPLETE WORKS OF ARISTOTLE 1729, 1746 (Jonathan Barnes ed., W.D. Ross trans., Princeton Univ. Press 1984) ("It is well said, then, that it is by doing just acts that the just man is produced, and by doing temperate acts the temperate man; without doing these no one would have even a prospect of becoming good.").

[164] This would be consistent with the recommendations of Professor Fletcher. *See* Fletcher, *supra* note 141, at 1149–53 (listing criteria for evaluating investor sophistication). However, Professor Fletcher explicitly excludes institutional investors from the reach of his screening regime by asserting that the presumption of institutional investor sophistication "should be . . . conclusive." *Id.* at 1153. This Article, informed by the financial crisis of 2008, does not endorse this view.

[165] A contrary view might be that allowing investors to diversify their holdings by buying securities in private offerings actually reduces their risk. Professor Kelli A. Alces has argued that a portfolio containing securities governed by different legal regimes can have this effect. Kelli A. Alces, *Legal Diversification*, 113 COLUM. L. REV. 1977, 1980 (2013). The empirical question that must be answered, then, is whether investing in private offerings results in more or less overall risk to an

Such an approach would draw implicitly on the insights of the academic literature analyzing the relative abilities of different kinds of entities to manipulate complex systems in their favor.[166] Companies that frequently purchase complex securities are more likely to be sophisticated, for example, and more likely to have accumulated the expertise to protect themselves from potential deception. Because such investors are more likely to have purchased such securities in the past, they are more likely to have experienced a variety of investment outcomes and to have invested in instruments to avoid potential losses. Repeat players, thus, have a stronger incentive to develop expertise in determining what a transaction is worth, the nature and magnitude of financial damage if it turns out poorly, and the appropriate steps to manage risk.

Pursuing the same goal through a slightly different path, regulations could focus more precisely on the sources of income earned by a would-be investor in a private offering. The greater the share of that income that was generated by investment activity actively managed by the individual or entity seeking accreditation, the more financially sophisticated that individual or entity is likely to be. The advantage of this tactic is its relative simplicity, resting as it does on modest, additional disclosures.

A more demanding screening mechanism for private offerings could create an incentive to game any approval process in the quest for higher returns. To weaken the power of this incentive, regulation of participation in private offerings could attach consequences; such investors, for example, could be required to waive certain types of claims or even to waive certain types of arguments in support of claims.[167] Disclaimers

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investor's portfolio—in other words, whether investors successfully use private offerings to reduce losses in other parts of their portfolios. It is not clear that public pension funds in particular have been so successful. *See* Roger Lowenstein, *How Pensions Make Investing Too Complex*, FORTUNE (Nov. 8, 2014), http://fortune.com/2014/11/08/how-pensions-make-investing-too-complex/ [http://perma.cc/CC83-P49R].

[166] *E.g.*, Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 113 (1974) (describing the process by which repeat litigators eventually "enjoy[] strategic advantages" in litigation systems). Works teasing out the implications of Professor Galanter's analysis in a variety of systems should also be examined. *Compare* Carrie Menkel-Meadow, *Do the "Haves" Come Out Ahead in Alternative Judicial Systems?: Repeat Players in ADR*, 15 OHIO ST. J. ON DISP. RESOL. 19, 30 (1999) (analyzing the ability of "[h]ave-not[]" repeat players to be successful in the official system of courts in personal-injury actions), *with id.* at 32 (noting the many ways repeat players access "alternative justice systems"). Scholars have also approached the question of manipulation of systems of dispute resolution from other perspectives. *E.g.*, John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020–21 (2012) (examining how financial regulatory reform legislation passed by lawmakers in response to financial crises is subsequently eroded as a result of lobbying by affected industries).

[167] At its core, this is an argument for some form of estoppel. Financial institutions that claim they were misled into purchasing certain assets, but who performed minimal or no due diligence before investing, should not then be permitted either to issue securities of their own through regulatory exemptions to registration requirements or to purchase securities sold pursuant to such exemptions.

would create a disincentive to participate in transactions that might be too exotic for those investors lacking the capacity to evaluate overly complex securities.[168]

More subjective investor characteristics should be taken into account as well. For example, evaluation of internal controls governing investment activity is already required of public[169] companies. Investors with weaker internal systems of internal controls[170] in place to discourage short-sighted purchases or monitor investment performance might be classified as less sophisticated, thereby incorporating considerations of corporate governance into the exemption regulatory regime.

The regulatory moves described above all recognize that financial market participants exist in a multidimensional space, and may simultaneously possess characteristics that suggest capacity to undertake a particular, complex investment safely, and characteristics that suggest an inability to do so. A more modern classification regime would evaluate investors in holistic fashion, considering both aptitude in the context of a particular transaction and past investment experience. Ideally, such a scheme would limit eligibility to reap the rewards of investing in potentially more complex securities to those best able to identify and manage the corresponding risks.

These reform proposals, which would limit access to private offerings, may raise concerns about excessive paternalism. This is more than an abstract concern: new, federal restrictions on investment in private offerings by state pension funds undermine state autonomy. A challenge to such limits, perhaps undertaken by a pension fund facing a significant

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This estoppel would create an incentive for institutional investors to perform more due diligence than many conducted prior to the 2008 financial crisis and, in cases of those institutions that fail to conduct adequate due diligence in the future, would help to prevent exposure to future losses that should have been avoided.

[168] There is a normative argument here, of course, that some investors should not participate in some transactions for the good of all investors. It is difficult to read the Financial Crisis Inquiry Report and not reach the conclusion that harmful effects of the crisis might have been avoided had fewer entities entangled themselves in deals involving securities, the value of which depended on home loans. In a provocative article questioning the power of disclosure to prevent poor investment decisions, Professors Steven M. Davidoff and Claire A. Hill suggest going further than I do. They call "for an 'unsafe harbor' under which investors attempting to justify their investment decisions to a court could not invoke reliance on third-party certification as their sole . . . decisionmaking technique." Davidoff & Hill, *supra* note 127, at 636.

[169] Here, I am using the word "public" as a term of art, the narrow sense in which it is used in securities regulation. *See* Definition of "Public", MERRIAM-WEBSTER UNABRIDGED DICTIONARY, www.merriam-webster.com/dictionary/public [http://perma.cc/3JN6-6WHB] (last visited Oct. 4, 2015) (defining public as "capitalized in shares that can be freely traded on the open market").

[170] There is a precedent for evaluation of such systems. The Sarbanes-Oxley Act of 2002, for example, requires a "registered public accounting firm" to prepare audits and approval of "internal control[s]" at publicly traded companies. Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (codified as amended at 15 U.S.C. § 7262(b) (2012)).

shortfall and seeking to use potentially riskier investments to bolster its income and meet its financial obligations, would compel development of a complex and shifting area of law. The outcome of such litigation could have unexpected effects—perhaps salutary, perhaps not—on the new private offering limits and on public pension investing practices more generally.

Perhaps changes in financial markets and the increasingly varied investor population are not so great a cause for concern. The rise of institutional investors,[171] in particular, means that overall, more investors should be more experienced and more capable of protecting their own interests, and that more individual workers and savers should have the benefit of the expertise of intermediary institutions. Recently, at least one scholar has argued for greater access to opportunities to invest in private placements.[172] However, fallout from the financial crisis has made clear that costs of poor investing practices are widely distributed. To limit participation in more complex and potentially risky transactions is a second-best solution, but the very nature of investments held by sophisticated entities makes it difficult, if not impossible, for an outsider, and possibly an insider, to gauge the potential costs of a mistake. Highly contingent investments are difficult to value, let alone net against each other. For example, executives at some of the financial institutions that proved to be overexposed to falling real estate prices were clearly unprepared for, and surprised by, the impact of the bursting bubble.[173] Taking into account the purpose of investment may provide a means of limiting the impact of such misjudgments.

B. *Investor Purpose: The Publicness Criterion*

No selection criteria can prevent all mistakes or eliminate the chance of losses on investments. The values of securities do not only increase; transactions can produce losers as well as winners. The question to wrestle with is: how much should those investment losses be permitted to undermine a public goal? While measures of experience, expertise, and resources should all figure in the evaluation of whether an investor should be permitted to buy potentially riskier securities through private offerings, an additional criterion should control—the purpose that the investor serves.

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[171] *See* Aguilar, *supra* note 128 (noting the increase in recent decades in the percentage of public company shares held by institutional investors).

[172] *See* Rodrigues, *supra* note 153, at 3430–34 (arguing that the general public should be permitted to participate in the private market using a structure akin to mutual funds).

[173] *See, e.g.*, Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES (Sept. 27, 2008), http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all (describing the plight of AIG, which received substantial government support to weather the financial crisis after its exposure to real estate prices went unnoticed until it was too late).

To the extent that an investor's mission is public in nature (meaning that the investor serves a goal that has greater societal significance and value) the risk of losses should be limited. The balance of this Part suggests how the "publicness" of an investor's mission could be evaluated and what the regulatory consequences should be.

If investment in private offerings would generate income for third parties, that would be a step toward publicness. But in many cases, large investors would respond that they buy both for themselves and for others. Who the others are must matter. Public pension funds present the easy case, while an insurance company might present a more difficult one. Investing on behalf of third parties alone does not confer publicness and additional questions help to clarify. If the third parties providing money for the investment are retail-level savers, such as workers who rely on a public pension fund and who, but for the fund as intermediary, would almost certainly not be investing in a private offering, that suggests a greater degree of publicness. If the third parties are financial institutions or wealthy individuals, on the other hand, that suggests that the investor does not serve a public mission.

An even clearer indication that an investor serves a public goal would be its mission statement, if it has one. An institution dedicated to administering retirement benefits on behalf of public employers, for example, serves a public goal.[174] Perhaps other missions could qualify, such as facilitating saving for higher education expenses, but the amounts held by public pension funds are far greater.[175] The development of a list of institutions or institutional goals classified as public could be a politically vulnerable process, but given that institutions are likely to seek to avoid limits on their investment options, the risk of such manipulation seems low.

If an investor serves a public mission, then regardless of its sophistication by other measures, its investments in private offerings would be limited. Determining the limit presents its own challenges, which highlight the absence of carefully considered baselines applicable to investment activity undertaken in the public interest.[176] As of this writing,

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[174] *E.g.*, *CalPERS at a Glance*, CALPERS (June 30, 2014), https://www.calpers.ca.gov/docs/forms-publications/calpers-at-a-glance.pdf [https://perma.cc/63EW-E9EZ] (noting over 3000 total employers in the CalPERS retirement program, including the State of California, school districts, and public agencies, all of whom serve a public function).

[175] *Compare Sources of Estimated Total U.S. Retirement Plan Assets, 2012*, EMP. BENEFIT RES. INST., http://ebri.org/publications/benfaq/retfaqt4.jpg [http://perma.cc/SWD2-5LLD] (last visited Sept. 18, 2015) (listing state and local government pension funds that together manage in total more than $4.5 trillion in assets), *with* Ron Lieber, *Taxing 529 Accounts: A Plan that Went Awry*, N.Y. TIMES, Jan. 31, 2015, at B1 (stating that 529 college savings plans hold about $240.7 billion).

[176] For example, multiple intermediary institutions complicate the inquiry. If a public pension fund invests in a hedge fund, which in turn pursues an opportunity in the form of a private offering, the

the default rule is that a pension fund may risk total loss on an investment, even if the potential result could be inability to perform its obligations. A far more conservative approach would prohibit investment if total loss would have an impact on obligations to third parties within a set period of time, perhaps a decade. The trigger level could be adjusted. The limit could apply if a 90% or a 50% loss would have an impact, for example; the maximum permissible size of the impact could also be adjusted, as could the time frame in which that effect would occur.

Perhaps there is a normative justification for allowing investors serving future retirees, for example, to risk total loss and resulting declines in payouts to beneficiaries, but the case needs to be made. The status quo, which ignores the public role that certain investing institutions play, cries out for explanation and justification.

Put another way, investors serving public purposes should satisfy requirements like those applicable to banks and some other financial institutions. Some institutions must evaluate and disclose the riskiness of particular investments, and methodologies exist for doing so. For example, the SEC requires registrants to disclose "value at risk," or VaR, defined as "the potential loss in future earnings, fair values, or cash flows of market risk sensitive instruments over a selected period of time, with a selected likelihood of occurrence, from changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates or prices."[177]

Some financial institutions, such as banks, must also perform "stress tests," which seek to determine how an institution would weather changing, adverse circumstances, like falling asset prices or counterparty defaults on obligations.[178] These simulations can be complex, taking into account the impact of an exogenous event on an entire portfolio, as well as the impact of performance of a single investment or investment class. Policymakers, thus, have a number of options in determining the steps that a public pension fund would have to take to establish its capacity to fulfill its public mission following investment in a private offering ranging from focus on the individual transaction to assessment of an entire portfolio.

Such requirements can be gamed. Various approaches to risk assessment exist and may be selected strategically. Overall, trust in investors' ability and willingness to evaluate risk accurately may be misplaced. These criticisms have been leveled at regulations mandating

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hedge fund may not necessarily be subject to the same limits as the pension fund. But the pension fund could be required to limit its exposure to the hedge fund's investments.

[177] 17 C.F.R. § 229.305(a)(iii)(A) (2014).

[178] *See* Robert Weber, *A Theory for Deliberation-Oriented Stress Testing Regulation*, 98 MINN. L. REV. 2236, 2238–39 (2014) (describing how "stress tests" help explain how financial systems respond to dynamic and adverse marked conditions).

assessment by banks, for example.[179] Hopefully in the case of pension funds, at least, the incentives should favor caution, in the interest of better serving beneficiaries. However, it is possible that requirements like those suggested in the preceding paragraphs could be manipulated.[180] Unless the harm of attempting to protect the public mission of a particular investor outweighs the benefit, the idea merits careful consideration.

It is well beyond the scope of this Article to develop a particular methodology for evaluation of risk, which is, itself, a question of great depth and complexity.[181] The core claim advanced is that such a methodology should be a prerequisite to investing in a private offering for investors with public missions. Demanding stress tests under multiple scenarios, in which other investments perform well or poorly, could be required in advance of particularly large and risky investments. The burden of the disclosure itself would function as a screen, with only investors more determined and able to satisfy regulatory demands going forward.

Beyond providing disclosure of risk exposure, a public-serving investor could be required to disclose how the impact of a loss, whether partial or total, would be managed. That plan could be submitted to an independent reviewer, such as an outside auditor, for approval and disclosure to the investor's third-party beneficiaries. Again, the extent of required risk management controls could vary with the riskiness of an overall portfolio and the degree to which the investor had the resources to honor its obligations within a particular time frame, among other factors. The standard could be adjusted, but first the need for it must be recognized.

The imposition of sanctions in cases in which investors incorrectly characterize their ability to withstand a total or partial loss on a particular transaction raises additional questions. There should be a penalty following deliberate misstatement—that is, misstatement made with scienter, as evaluated in any securities fraud action alleging violation of Section 10(b) of the Securities Exchange Act[182] and rule 10b-5[183] thereunder. Even in the

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[179] *See, e.g.*, Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 631 (2013) (describing the shortcomings of such regulations).

[180] Or simply applied mistakenly. As Professor Macey notes, "[t]he financial crisis [of 2008] . . . showed that many of the VaR models [banks relied on] used faulty historical data and assumptions." *Id.* at 633. Professor Macey voices concern that the existence of regulations may create an incentive to "alter . . . VaR models to lessen the apparent risk in what [is] actually an extremely risky series of actions." *Id.* at 634.

[181] The Investor Advisory Committee to the SEC has proposed that, if the Commission maintains hard financial thresholds for participation in private offerings, then it should consider "limiting investments in private offerings to a percentage of assets or income," a restriction that is perhaps more easily implemented. RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE, *supra* note 146, at 8.

[182] Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j (2012)).

absence of wrongful intent, though, an investor might be barred from future private offerings in the wake of a poor outcome in a past such investment.[184] The poor outcome would need to be disclosed to those whose savings provide the investor with financial resources.

The purpose of modifying the exemption regime applicable to private offerings to take into account investor purpose is not simply to protect particular investors, however sympathetic public pension plans may be. So far, public pension funds generally buy securities on public exchanges rather than through private placements. Nor is the goal to exclude unsophisticated, wealthy investors from these transactions simply because they are unsophisticated. In financial transactions, as elsewhere, someone often wins and someone loses. This Article does not suggest that investors should be protected from losses every time that they make a poor decision.

But too many poor decisions and resulting losses may affect the achievement of specific, desirable public goals, and those risks must, at times, outweigh the right of investors to participate in particular transactions.[185] The potentially public effects of investment outcomes in private offerings make them properly subject to restrictions. Government regulatory constraints on investor conduct under these circumstances seem reasonable because government policies that facilitate the entrusting of public goals to pension funds make it possible for those entities to earn quite a lot of money. The imposition of these restrictions would not be as extreme a step as it might appear at first blush because the SEC amended securities regulations not so long ago, in 1989, to enable public pension funds to invest in private offerings.[186] Before 1989, access to private offerings was not limited in the nuanced and flexible way that this Article proposes—it did not exist.

Applying the various tests described above, an extremely wealthy individual with little expertise might, nonetheless, be permitted to invest in a private placement involving a highly complex security, but a public pension fund with billions of dollars under management might not. The same criteria conceivably could apply to private pension funds and even other institutions that invest for the benefit of retail third parties. In the

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[183] 17 C.F.R. § 240.10b-5 (2014) ("It shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security.").

[184] *See supra* note 160 and accompanying text (advocating for the SEC to propose a nuanced definition of "accredited investor," which would require that investors earn the right to future investment).

[185] Excessive risk-taking may also harm the health of the financial system on which investors rely, and that system's functioning may be considered a public goal as well. But that is not the emphasis of this Article, as systemic risk is already a recognized priority of financial regulation.

[186] *See* Accredited Investor and Filing Requirements, 54 Fed. Reg. 11369 (Mar. 20, 1989) (amending 17 C.F.R. pts. 200, 230, and 239 to modify the definition of "accredited investor" to include government benefit plans). The then-new rule, 17 C.F.R. § 230.215, effected the change, and remains in force.

absence of a policy discussion over which institutions serve public ends and which do not, a principled distinction is elusive. The discussion below briefly illustrates how the above criteria might apply using the case of the San Diego pension fund described in Part I.

C. *A Brief Case Study: SDCERA Revisited*

The litigation involving SDCERA, discussed above,[187] illustrates how the current investor classification scheme for private offerings manages to be simultaneously overbroad and under-inclusive by barring investors that may have the knowledge and skills to evaluate the risk posed by transactions from private placements, while admitting investors that lack the abilities and resources to evaluate risk and cope with poor investment outcomes. An investor may have the experience and intelligence to analyze a transaction and determine whether it is suitable,[188] even though that investor does not have significant wealth or income; conversely an investor with sufficient assets may qualify as accredited or sophisticated even if utterly lacking in expertise. Further, and as a result, the classification regime may bar recovery through ex-post litigation even in the wake of potentially fraudulent conduct because a court may find itself compelled to conclude that a sophisticated investor should have better understood and investigated the transaction before entering into it. SDCERA fell victim to this Catch-22.[189]

Before describing the litigation, very briefly, here are the elements of the kind of fraud claim made by SDCERA. The Supreme Court has identified six elements of a fraud claim under Section 10(b) of the Exchange Act and its implementing regulation, Rule 10b-5: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[190] The Court has defined scienter as

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[187] *See supra* Part I.

[188] *See Suitability*, FIN. INDUS. REG. AUTHORITY, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13390&element_id=9859&highlight=2111 [http://perma.cc/G8XV-3GGW] (last visited Sept. 18, 2015) (describing the requirement of the self-regulatory agency of securities firms that brokers limit their investment recommendations to securities "suitable" for the clients they serve). Among the factors that a broker may consider in determining which investments are appropriate for a particular client are "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." *Id.*

[189] San Diego Cnty. Emp. Ret. Ass'n v. Maounis, 749 F. Supp. 2d 104, 121 (S.D.N.Y. 2010) (finding the sophistication of SDCERA made its investigation advisor's reliance on allegedly fraudulent statements unreasonable as a matter of law).

[190] Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2184 (2011) (quoting Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1317 (2011)).

a mental state embracing "intent to deceive, manipulate, or defraud."[191]

To date, in cases involving claims of securities fraud, the Supreme Court has not addressed the question of whether reliance by the plaintiff on an allegedly false statement or omission must be reasonable. This is so because the cases that have reached the Court have involved class actions in which plaintiffs typically have invoked the presumption of reliance allowed under the "fraud on the market" theory recognized in *Basic Inc. v. Levinson*.[192]

However, lower courts hearing individual actions have wrestled with the question of the reasonableness of reliance and, in cases pitting large investors against large financial companies, that determination often poses a significant stumbling block for institutional 10b-5 plaintiffs.[193] For SDCERA, this was the problem—it was too sophisticated an investor to have been defrauded, as the institution's lawyers argued it had been. Indeed, under the current regime governing access to private offerings, SDCERA was sophisticated. The same conclusion might well be reached after applying the tests of investor characteristics as proposed above. But the "publicness" criteria would create a high bar to the hedge fund investment that cost SDCERA more than $150 million.[194]

According to its complaint, SDCERA invested $175 million in Amaranth Partners (the "Fund"), a hedge fund, in 2005,[195] in a private offering.[196] SDCERA alleged that Amaranth misrepresented and fraudulently concealed its investment strategy, hiding the fact that the Fund "operated as a single-strategy natural gas fund that took very large and highly leveraged gambles," and not as a diversified investor as was claimed.[197] When the price of natural gas fell in the fall of 2006, the Fund began to lose money and lenders began demanding repayment of loans that had helped fuel its natural gas purchases.[198] Ultimately, the Fund lost more

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[191] Ernst & Ernst v. Hochfelder, 45 U.S. 185, 193–94 & n.12 (1976).

[192] Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . ." (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3rd Cir. 1986))).

[193] *See* Glater, *supra* note 14, at 88 ("[For] investors who purchased securities through a private placement and subsequently allege[d] fraud . . . the challenge . . . is more likely to be demonstrating reasonable reliance . . . .").

[194] Complaint at 2, San Diego Cnty. Emp. Ret. Ass'n. v. Maounis, 749 F. Supp. 2d 104 (S.D.N.Y. 2007) (No. 07-CV-2618).

[195] *Id.* at 2.

[196] *See id.* at 11 (stating that "[t]he Fund was structured as an unregistered pooled investment, privately organized and administered by Advisors, a professional investment manager").

[197] *Id.* at 2.

[198] *Id.* at 33 (stating that "[b]y September 28, 2006, the spread fell to 42 cents . . . [and] SDCERA issued a written request for full redemption").

than $6 billion.[199] SDCERA sued to recover on its investment.[200]

Would SDCERA have been able to invest in Amaranth had it been subject to the classification regime presented above and given its mission to serve county employees? SDCERA is a public pension fund, as clearly stated on its website.[201] It has an explicit public mission: to provide for the retirement income of employees of San Diego County.[202] These employees are third parties and retail savers, not other financial institutions with resources of their own. SDCERA's investment in private offerings consequently would be subject to limitations, and the only question would be the nature and extent of those limits. The answer would turn on the institution's ability to make payments to its beneficiaries over a period of ten years, assuming a total loss of its $160 million investment. This disclosure would have to include anticipated rates of return on the rest of the institution's portfolio over the same period of time, thus giving some idea of the ease of managing the total loss. Further, SDCERA could be required to provide a description of a plan to mitigate the risk of the investment, by identifying hedges against the private offering, for example. As a result of these various constraints, SDCERA could very well have been barred from participating in the private offering and not suffered losses that hampered its ability to serve the county employees relying on it.

V. CONCLUSION

This Article has described a regime directly addressing the problem of classifying investors, some of which may lack the ability to conduct due diligence even when they have the will to do so, some of which may lack the resources to monitor investments once made even if they do have the expertise to evaluate a transaction, and some of which may lack the means to absorb losses and still fulfill valued, public obligations. The participation of such an investor in private placements is risky to the investor, of course, but also to counterparties, counterparties to those counterparties, and beneficiaries of the investor, who all suffer the fallout when a transaction generates losses.

Post-financial crisis securities litigation has highlighted the inadequacy of the current regime governing eligibility to invest in private offerings, which has permitted investors with significant assets but perhaps a degree of sophistication that is not commensurate to participate in complex and risky transactions. Market participants have grown more diverse, but the categories into which they are divided have not; the definition of

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[199] *Id.* at 2.

[200] *Id.* at 1–2.

[201] *Pension Facts*, SAN DIEGO CNTY. EMP. RET. ASS'N, http://sdcera.org/pension_facts.htm [http://perma.cc/7WU5-22VS] (last visited Sept. 19, 2015).

[202] *Id.*

"accredited investors" requires careful rethinking. Further, investments increasingly serve public ends, providing retirement income to workers, for example. The classification regime outlined in this Article takes into account the purpose of the investment, thus addressing the particular risks posed by poor decisions by institutional investors that manage assets intended to perform significant, public roles.

The concept of publicness is challenging to explore, and defining its scope requires wrestling with deep questions about what serves a common interest. Although this Article has focused on a more manageable subset of investors, public pension funds, and the particular regulatory regime governing access to private offerings, the implications of developing a broader and more complex understanding of what it means to be public extend much further and could encompass a variety of additional financial intermediaries providing income to support other public policy goals. The goal of this Article is to broaden the conversation about publicness, recognizing that there are myriad means by which we collectively seek to achieve public ends.