Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States: Part II

BEAT D. SPECK* AND JOSEPH TANEGA**

* *LL.B., LL.M.; Attorney at Law & Civil Law Notary, Wenger & Vieli, Zurich/Zug, Switzerland*
** *B.A. Princeton, M.Phil Oxon, Juris Doctor; Attorney at Law; Senior Lecturer International Financial Law, University of Westminster, School of Law, London*

LT Comparative law; EC law; Financial regulation; Private equity; Securities markets; Switzerland; United Kingdom; United States

Introduction

This article is the second part of a two-part series concerning the legal aspects of private equity placements in Switzerland with a comparative analysis of the relevant legal regimes in the European Union, the United Kingdom and the United States. It is published in two parts, with Part I focusing on the Swiss and the EU legal framework,[1] and Part II focusing on the laws of the United Kingdom and the United States. We begin with a summary of the relevant legal framework in Switzerland and the European Union, and then move on to an analysis of the UK and US regimes.

Summary of the current legal framework in Switzerland

The formalities for private placements in the Swiss market are remarkably simple. The issuance of equity securities is not subject to review, clearance or registration with any governmental or self-regulatory body. Nor does the relevant prospectus need to be reviewed by or registered with any governmental or self-regulatory authority.[2] If shares are issued without a prospectus, or if the information contained in the prospectus is false or misleading, the persons responsible for such may only be held liable ex post for damages.[3] Moreover, financial promotion and investment advice appear to be unregulated subject to certain industries being regulated due to their principal business, such as banks, insurance companies and pension funds. Under Swiss law, there are no supervisory regulations governing asset managers or financial advisers giving advice to their customers, nor is there any regulation or supervision governing the promotion and marketing of the selling documents attending to this process.

Article 652a of the Code of Obligations 1911 (''CO'')—notably the only provision in Swiss law which regulates (indirectly) private placements—is weakened by its failure to draw a clear distinction between public offerings (where a prospectus is required to be drawn) and private placements (where there is no requirement, but often an offering memorandum is drawn up for marketing purposes). In addition, secondary distributions are not covered by the provision, nor are international offerings which are placed in Switzerland. In revising Art.652a CO, the Swiss law-maker would be well advised to address these gaps.

Summary of the current legal framework in the European Union

The European Union provides a very broad definition of public offerings.[4] In order to avoid the absurdity of regulating all offerings, and because of market pressure exerted by trade associations, market participants and national regulatory bodies, the European Union has exempted certain transactions from the definition of a public offer.[5] Moreover, investment advice in the European Union is carefully regulated. The relevant Markets in Financial Instruments Directive,[6] the successor of the Investment Services Directive (''ISD''),[7] requests that by April 2007, all Member States should authorise all investment firms, including financial advisers, placement agents, and others, that render financial advice and place securities in the market. However, financial promotion per

1. See [2006] J.I.B.L.R. 213 *et seq.*
2. Homburger, *Effekten Transaktionen in Europa: Schweizer Kapitel* (London, 2003), para.60-000.
3. Daniel Daeniker, *Swiss Securities Regulation* (Zurich, 1998), p.61.
4. See Prospectus Directive 2003/71 [2003] O.J L345/64, Art.2(1)(d).
5. These include: (i) sales to qualified investors, i.e. legal entities or the sophisticated rich (having assets of more than €0.5m) private purchasers, (ii) sales to fewer than 100 unqualified investors, (iii) sales with a total consideration of greater than €50,000 per share, (iv) sales with a minimum share denomination of €50,000, and (v) sales with a total consideration not exceeding €100,000.
6. Directive 2004/39 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] O.J. L145/1.
7. Council Directive 93/22: [1993] O.J. L141.

se is hardly dealt with.[8] Finally, the Distance Marketing Directive allows retail customers to step back from certain types of contracts if they were entered into exclusively through the use of distance means (such as telephone, fax, internet or mail). According to a leading US commentator,[9] the European Union should, in addition to the measures already in force, develop a mandatory, internet-accessible electronic filing system for all prospectuses and public reports (similar to the US-EDGAR system). The same commentator suggests that the European Union should re-establish the European Securities Committee as an independent administrative agency.[10]

The current legal framework in the United Kingdom

Introduction

Since the end of 2001 the UK financial markets have been largely regulated by one single statute, the Financial Services and Markets Act 2000 (''FSMA''), which in turn confers extensive powers on a single regulator, the Financial Services Authority (''FSA'').[11] The principal argument for unifying regulatory responsibility in one body was that the distinctions between the different types of financial institutions and the boundaries between activities being undertaken were blurring.[12] The main reason for this change can be traced to 1997, when the Chancellor of the Exchequer, in one of the first announcements made by the incoming Labour Government, stated that the Government intended to reform the UK regime for the regulation of financial institutions. The extent of the Government's radicalism in reforming financial regulation took many practitioners and commentators by surprise.[13] However, the main purpose of the proposal was to create a single, statutory regulator for the full range of financial businesses and markets, covering not only banking and insurance (including Lloyds), but also commodities, fund management, retail brokerage, and the on- and off-exchange traded securities markets. Hence this giant regulator, the FSA, was to replace no fewer than nine pre-existing regulatory bodies.[14] The FSA has set out four statutory regulatory objectives[15] and seven regulatory principles.[16]

The Financial Services Authority

The FSA is said to be one of the most powerful financial services regulators in the world in terms of scope, powers and discretion.[17] Such ''one-stop'' regulation clearly has significant advantages, most importantly, at least in theory, duplications and inconsistencies can be avoided and regulatory gaps filled.[18] In doing so, the United Kingdom set the trend in so-called ''regulatory consolidation'' by establishing a single regulator encompassing cross-sectoral supervision, regulating both the prudential and the conduct of business aspects of business as well as conferring strong powers on the regulator in terms of the authority to legislate, monitor, investigate and sanction all activities regarding investment activities.[19] The British exemplar may be emulated to some extent by the Swiss who intend to enlarge considerably the powers of the Federal Banking Commission (''FBC'').[20]

The Financial Services and Markets Act 2000

By the time the Financial Services and Markets Bill received Royal Assent in 2000, it had grown to a rather impressive size with 433 sections and 22 schedules, not to mention the numerous statutory instruments in place to date.[21] Despite its length, it

8. Save the relevant provisions in the E-commerce Directive 00/31: [2003] O.J. L178/1.

9. i.e. Manning Gilbert Warren III, *European Securities Regulation* (The Hague/London/New York, 2003), p.11.

10. An agency, that would, in addition to its rulemaking authority, ''help develop and monitor the proposed centralised clearance and settlement system, maintain the proposed centralised filing system, collect and disseminate compliance and enforcement data, coordinate Member State enforcement of EU securities laws and regulations, monitor the administration of alternative dispute resolution proceedings, and provide consumer education to retail investors to further develop and protect its unified retail securities market''. See Warren III, fn.9 above, p.11.

11. *Securities Transactions in Europe* (Sweet & Maxwell, looseleaf), para.10-000.

12. Gerard McMeel and John Virgo, *Financial Advice and Financial Products—Law and Liability* (Oxford, 2001), para.1.09.

13. Taylor, in Michael Blair *et al*., eds, *Blackstone's Guide to the Financial Services and Markets Act 2000* (London, 2001), p.1.

14. Eva Lomnicka and John L. Powell, *Encyclopedia of Financial Services Law* (London, 2004), para.2A-001; Taylor, fn.13 above, p.1.

15. i.e. market confidence, public awareness, consumer protection and the reduction of financial crime (s.2(2) FSMA).

16. i.e. (i) the need to employ its resources in the most efficient and economic way, (ii) the responsibilities of the managers of financial services firms, (iii) the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits which are expected to eventuate, (iv) the desirability of facilitating innovation in the regulated markets, (v) the international character of financial services and markets and the desirability of maintaining the competitive position of the UK, (vi) the need to minimise the anti-competitive effects of regulation, and (vii) the desirability of facilitating competition between regulated firms (s.2(3)(a)–(g)).

17. Taylor, fn.13 above, p.2.

18. Eliahu Peter Ellinger, Eva Lomnicka and Richard Hooley, *Modern Banking Law* (Oxford, 2002), p.37.

19. Lomnicka and Powell, fn.14 above, para.2A-002. The rules and guidance of the FSA are collected in a ''Handbook'' which is divided into numerous ''Sourcebooks'' or ''Manuals'', each of which is known by an acronym (e.g. ''AUTH'' for ''Authorisation Manual'').

20. Bill on the prudential supervision of the financial market (*Finanzmarktaufsichtsgesetz*; FINMAG), yet to be published.

21. More than 80 statutory instruments to date (McMeel and Virgo, fn.12 above, para.1.06). See also Karen Connolly, ''The Financial Services and Markets Act 2000: Secondary

remains a framework provision similar to EU level 1 legislation,[22] conferring extensive powers on the Treasury[23] and the FSA to devise the details of the regulatory regime by secondary legislation. The Act was brought into force on December 1, 2001 (the so-called ''N2'' day).[24]

Part II of the Act sets forth the ''general prohibition''—that is, only an authorised or an exempt person may carry on, or may purport to carry on—a regulated activity[25] from the United Kingdom.[26] The scope of the concept of regulated activity is broadly defined in s.22 FSMA. Such activities are to be specified by the Treasury in secondary legislation.[27] In order to become an authorised person one needs to obtain permission from the FSA under Pt IV FSMA.[28]

UK rules and regulations affecting private placements

Implementing the EU Prospectus Directive

In the United Kingdom, the implementation of the European Prospectus Directive by July 2005 1, has required significant amendments to the old legislation, in particular Pt VI FSMA.[29] The existing regime for public offers of non-listed securities contained in the Public Offers of Securities Regulations 1995[30] was superseded in its entirety. The Listing Rules were revised to implement the Directive's more detailed provisions on approval, form and content of prospectuses. In October 2004, HM Treasury and the FSA published consultation papers with proposed laws, regulations and rules.[31] Both noted that the Directive is largely a maximum harmonisation directive, in relation to the format and contents of a prospectus, and that the Directive is highly prescriptive. Consequently, there is limited scope for EU Member States to apply discretion in the way in which they implement it.[32]

As stated above, the Directive was implemented in UK law mainly through amendments to two key components of the existing regime: Pt VI FSMA as well as Schs 7–11[33] and the Listing Rules.[34] While a full analysis of the content of these consultation documents and the statutory amendments is outside the scope of this paper, it is important to highlight the fundamental changes to the UK regulatory regime, and where the Treasury has voiced concerns. These include the definition of what constitutes an offer to the public and the new exemption for public offers below €2.5 million.

In relation to the former, the Treasury proposed to adopt a copy-and-paste approach, incorporating the definition directly into Pt VI FSMA, but including a clarification that a public offer does not include a communication in connection with trading on a regulated market, such as the London Stock Exchange, a multilateral trading facility or any market prescribed for the market abuse regime under s.118 FSMA.[35] This proposal was finally adopted.[36]

With respect to the latter, the Treasury noted that the combined effect of the new exemption and the removal of the Public Offers of Securities Regulations regime, under which public offers in excess of £100,000 required a prospectus to be produced and filed at Companies House, is that there will now be a regulatory gap for offers between £100,000 and €2.5 million. It was particularly concerned that the quantum of the increase is significant and that reckless and unscrupulous promoters will be encouraged to undertake capital raising in full cognisance that a prospectus will not be required, to the detriment of investor protection.[37] However, in consultation, all but two respondents were of the view that €2.5 million is an entirely appropriate level at which an offering should be deemed to require a prospectus as a matter of law; hence the vast majority did not consider a sub €2.5 million regime necessary, given the associated cost and time burdens, particularly for smaller firms.[38] The Treasury thus did not deviate from the Prospectus Directive.[39]

But the financial promotion regime will apply to communications outside the scope of the Directive,

Legislation under the FSMA'' (2001) 3 J.I.F.M. N91–92, para.91.

22. See [2006] J.I.B.L.R. 222.

23. Primarily to define the scope of the regime by Order.

24. Lomnicka and Powell, fn.14 above, para.2A-004.

25. Specified by the FSMA (Regulated Activities) Order 2001 (SI 2001/544). The Order encompasses, inter alia, dealing in investments, making arrangements for or with a view to investment transactions, and giving advice to persons in their capacity as investors on the merits of investment transactions.

26. s.19 FSMA.

27. McMeel and Virgo, fn.12 above, para.4.35.

28. An applicant for authorisation is required to satisfy specified threshold conditions, such as adequacy of resources and ''suitability'', i.e. that the applicant is a ''fit and proper person'' (*Securities Transactions in Europe*, fn.11 above, para.10-040).

29. See SI 2005/1433.

30. SI 1995/1537.

31. HM Treasury/FSA, *UK implementation of the Prospectus Directive 2003/71/EC—A consultation document* (London, 2004), pp.1 *et seq.*, available from *www.hm-treasury.gov.uk*.

32. Rosali Pretorius and Jamile Ferreira, ''The Implementation of the New Prospectus Directive in the United Kingdom'' [2005] J.I.B.L.R. 56–64, p.57.

33. The Treasury proposed to amend these schedules so as to extend the scope of the regime to include offers to the public of non-listed securities and admissions of securities to trading on a regulated market, previously covered by the Public Offers of Securities Regulations.

34. The intent is to extend their scope and to incorporate some new continuing obligations imposed by the Directive.

35. HM Treasury/FSA, fn.31 above, paras 4.7 *et seq.*

36. See s.102B FSMA, in particular subss.5 *et seq.*

37. HM Treasury/FSA, fn.31 above, paras 4.13 *et seq.*

38. HM Treasury, *Final Regulatory Impact Assessment* (London, 2005), para.50, available from *www.hm-treasury.gov.uk*.

39. See Sch.11A, para.9 FSMA.

such as offers below €2.5 million. This regulatory regime should be adequate to protect investors from reckless and unscrupulous promoters. It has the effect of restricting access to the retail market. The Treasury may wish to consider whether to replace the definitions of sophisticated and high net worth individual investors in the Financial Promotion Order (see below) with a reference to the ''qualifying investor'' regime implemented under the Prospectus Directive. Such an objective measure would have the merit of making it much easier to judge whether an investor may be targeted by an unauthorised institution or not.[40]

Financial Promotion Order 2001

One of the striking innovations of the new regime under the FSMA is the introduction of a unified and media-neutral financial promotion regime.[41] According to s.21 FSMA, financial promotion by an unauthorised[42] person is generally restricted.[43] An unauthorised person may carry out a financial promotion only if an exemption applies or if the content of the financial promotion has been approved by an authorised person. Therefore, unlike in Switzerland, individuals in the United Kingdom should be mindful of the requirements of the FSMA before they even communicate a business plan to potential investors.[44] Sending a business plan to, or discussing it with, potential investors, is a financial promotion which falls under s.21 FSMA. This may require the sender or other persons involved in the process to be authorised in the United Kingdom or to ensure that the advertisement is approved by an authorised person. In some cases, if a person does not comply with these rules, he or she would be committing a criminal offence[45] and/or agreements entered into may not be enforceable against recipient parties.[46]

The provisions are deliberately drafted very broadly in terms of potential application and territorial scope, but HM Treasury is given power to exempt certain communications by Order.[47] The Treasury did so in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.[48] Chief among these exemptions and of particular relevance for the structuring of private placements are those set forth below. Hence the financial promotion restrictions do not apply to any communication which is made only to the following recipients:

(i) investment professionals[49];
(ii) persons in the business of placing promotional material[50];
(iii) joint enterprises[51];
(iv) certified high net worth individuals[52];
(v) sophisticated investors[53]; or
(vi) associations of high net worth or sophisticated investors.[54]

Liability

Misstatements in, and omissions from, (private placement) information memoranda can give rise to both civil (contract, tort, deceit, misrepresentation) and criminal liability for those responsible in the United Kingdom.[55] We examine each in turn.

A legal analysis of the situation wherein an investor subscribes for securities is that the investor will have entered into a *contract*, wherein the information documents form the basis of the agreement with reciprocal representations and warranties therein. If these documents are wrong or misleading, then under normal contractual principles, the investor may be entitled to contractual remedies including damages, rescission and specific performance depending on the nature of the agreement.

40. Pretorius and Ferreira, fn.32 above, p.64.
41. McMeel and Virgo, fn.12 above, para.13.01.
42. Financial promotion by authorised persons is governed by the FSA's Handbook, more particularly in the Conduct of Business Sourcebook. Breach of a rule may expose a firm to private or public disciplinary action.
43. s.21(1) reads: ''A person ('A') must not, in the course of business, communicate an invitation or inducement to engage in investment activity''. Paragraph 2 goes on: ''But subsection (1) does not apply if (a) A is an authorised person; or (b) the content of the communication is approved for the purposes of this section by an authorised person.''
44. British Venture Capital Association, *A Guide to Private Equity* (London, 2004), p.15, available from *www.bvca.co.uk*.
45. Punishable by up to two years' imprisonment and/or an unlimited fine (s.25 FSMA).
46. s.30 FSMA (BVCA, fn.44 above, pp.51 *et seq.*; Hiren B. Mistry, ''Battle of the Regulators: Is the U.S. system of Securities Regulation better provided for than that which operates in the United Kingdom?'' (2002) 4 J.I.F.M. 137–142, pp.138 *et seq.*).
47. Blair, in Michael Blair *et al.*, eds, *Butterworths Annotated Guide to the Financial Services and Markets Act 2000* (London, 2003), p.32.
48. SI 2001/1335.
49. s.19 FPO. ''[. . .] whom the person making the communication believes on reasonable grounds to be investment professionals; or may be reasonably regarded as directed only at such recipients''.
50. s.38 FPO. ''[. . .] whose business it its to place, or arrange for the placing of, promotional material provided that it is communicated so that he can place or arrange for placing it''.
51. s.39 FPO. ''[. . .] by a [potential] participator in a joint enterprise to another participator in the same joint enterprise in connection with or for the purposes of that enterprise''. ''Joint enterprise'' means an enterprise into which persons enter for commercial purposes related to a business carried on by them.
52. s.48 FPO. ''Certified high net worth individuals'' in the sense of this provision means any individual (i) who has a current certificate of high net worth and (ii) who has signed a respective statement. Criteria to issue such a certificate are an annual income of not less than £100,000 and net assets of at least £250,000.
53. s.50 FPO. Being a ''sophisticated investor'' means any person (i) who has a current certificate signed by an authorised person to the effect that he is sufficiently knowledgeable to understand the risk associated with that description of investment and (ii) who has signed a respective statement.
54. s.51 FPO. This provision refers to Business Angels or Investment clubs and/or associations.
55. David Adams, *Corporate Finance: Banking and Capital Markets* (Bristol, 2004), p.277.

Liability in *tort* arises if a person who has relied on a misstatement suffers loss and the person who made the misstatement owed a duty of care[56] towards the person allegedly injured.[57] Where an investor acts upon a material misstatement of fact and suffers loss, he has an action in damages for *deceit* if the misstatement was fraudulently made.[58] Finally, a person may be able to rescind the subscription agreement or claim damages under the Misrepresentation Act 1967 if he acted upon an incorrect, misleading or omitted statement contained in the information documents.[59]

Section 397 FSMA makes it a criminal offence[60] for any person knowingly or recklessly to make a misleading, false or deceptive statement, promise or forecast, or dishonestly to conceal any material facts, if he does so for the purpose of inducing another person to enter, or offer to enter into a ''relevant agreement'' or to exercise or refrain from exercising rights conferred by a relevant investment. Several subsections make even stricter provisions where errors and omissions from information documents give rise to criminal penalties.[61]

Summary

In order to avoid (most of) the existing rules and regulations governing the public offer of securities to the public in the United Kingdom, an unlisted issue may be structured as a private placement by ensuring that no offering to the public is made according to the European Prospectus Directive.[62] As it constitutes a piece of maximum harmonisation legislation, Member States have limited scope to apply discretion in the way in which it is implemented.

Since the Labour Party took office in the United Kingdom in 1997, financial promotion and investment advice have been, inter alia, heavily regulated. The catch-all FSMA in accordance with the FSMA (Financial Promotion) Order 2001[63] set the tone and required all potential financial players in the United Kingdom to be authorised by the regulator. The FSA has been tasked under the FSMA to supervise all the previously authorised firms. As regards financial promotion, the Financial Promotion Order 2001 covers all means of communication in a media-neutral manner.

The UK liability regime for misstatements in, and omissions from, information memoranda can give rise to both civil (contract, tort, deceit, misrepresentation) and criminal liability for those responsible. Whilst it is not as onerous as its US counterpart,[64] it appears to be prohibitive enough to discourage potential wrongdoers. Indeed, the regime sets out a high burden of detailed regulatory control, and even for experts in this field, determining the right cause of action within the complex set of rules proves to be a difficult task.

Thus, according to the chairman of the British Venture Capital Association, for example, the UK private equity industry is one of only two regulated private equity and venture capital industries in the world.[65] Since private equity firms based in the United Kingdom are considered to carry on a form of investment business, they must comply with and are regulated by the FSA. It is noteworthy that in many countries—and particularly in the United States[66]—such firms may not be subject to securities regulation at all.

The current legal framework in the United States

Introduction

General

Under Art.I, s.8 of the US Constitution, the US Congress, the legislative branch of the federal government, is authorised to pass laws that govern commerce among states and between states and other nations (''the Commerce Clause''). Whilst the Commerce Clause forms a basis for securities regulations, the impetus for securities market regulation occurred with the 1929 stock market crash. In the years following this event, Congressional hearings were held to examine its cause, and led to the enactment of the Securities Act 1933, often referred to as the ''truth in securities'' law, and the Securities Exchange Act 1934.[67] Basically, the Securities Act 1933 deals

56. However, a duty of care arises only in the case of a special relationship between the person giving the wrongful information and the trusting person.

57. See the rule in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465.

58. i.e. if it was made either (i) with knowledge that the statement was false; (ii) without belief in its truth; or (iii) recklessly, careless whether it be true or false. The burden of proof rests on the plaintiff to establish that the false statement was made fraudulently.

59. Nevertheless, a claim for damages may be brought only against the other contracting party. A secondary market purchaser would not have a cause of action. For further details see Derek Mayson, Stephen French and Christopher Ryan, *Mayson, French & Ryan on Company Law* (21st edn, Oxford, 2005), pp.203 *et seq.*

60. Each offence is punishable by imprisonment and/or a fine (s.397(8) FSMA).

61. Errors in, and omissions from, information documents may also give rise to criminal penalties under other provisions, e.g. s.24 or s.398 FSMA and/or s.19 of the Theft Act 1968.

62. See [2006] J.I.B.L.R. 223 *et seq.*

63. SI 2001/1335.

64. See p.262 below. Some might say however that it is more onerous because it covers a broader range of situations.

65. Ann Glover, ''The economic impact of private equity and venture capital in the UK'', BVCA Chairman's Speech (November 1, 2004, London), p.3.

66. The US is commonly held to be the most successful environment for private equity placements.

67. Mark Berman, *A Practitioner's Guide to SEC Regulation outside the United States* (London, 2003), p.2; Thomas L. Hazen, *The Law of Securities Regulation* (3rd edn, St Paul, 1996), pp.6 *et seq.*; Marc I. Steinberg, *Understanding Securities Law* (3rd edn, New York, 2001), p.1.

with the initial offer and sale of securities while the Securities Exchange Act 1934 is primarily concerned with trading and regulation in the secondary markets. However, the ''Securities Act of 1933 did not spring full grown form the brow of any New Deal Zeus''.[68] It followed a generation of state regulation and several centuries of legislation in England.

In enacting the first of these acts, Congress was faced with the decision as to what regulatory philosophy the act should fulfil. The operating models that it considered were a ''fraud act'' with strict enforcement measures[69] and a ''merit regulation'' with a respective ''disclosure'' model.[70] The approach that prevailed was disclosure. The basic philosophy of the federal securities laws was then, and is today, full and fair disclosure in order to make an informed investment decision.[71]

The reach of US securities law is very broad. As a rule, any issuer who makes a public offering of securities in the United States or to US persons must file a so-called registration statement with the Securities and Exchange Commission (''SEC''), and must comply with the extensive initial and ongoing disclosure requirements of the US securities laws.[72] Issuers who wish to avoid this obligation must, therefore, ensure that they either do not offer their newly issued securities to the public (private placements) or they do not sell securities in the United States or to US persons (international offerings).[73]

The federal securities laws

The federal securities laws with which the SEC is concerned are as follows:

(i) Securities Act 1933[74];
(ii) Securities Exchange Act 1934[75];
(iii) Public Utility Holding Company Act 1935[76];
(iv) Trust Indenture Act 1939[77];
(v) Investment Company Act 1940[78];
(vi) Investment Advisers Act 1940.[79]

These laws are often amended from time to time. Examples of laws that have been passed to amend US federal securities laws include the Private Securities Litigation Reform Act 1995, the Gramm-Leach-Bliley Act 1999 and, most importantly, the Sarbanes-Oxley Act 2002. In this way, the US federal securities laws remain not only true to their original structure, which has lasted for more than seven decades with relatively little fundamental change, but also reflect current developments.[80]

The Securities and Exchange Commission

The SEC is the US federal agency charged with administering and enforcing the US federal securities law. It is an independent agency, operating under the Executive branch of the government and is subject to Congress only, including for approval of budgets.[81] It consists of five commissioners, each of whom is appointed by the President, and one of whom serves as chairman. Each serves a five-year term. The SEC comprises operating divisions, offices and operating centres (mainly for routine examination and enforcement matters) throughout the United States.[82]

The question of whether or not US securities regulation applies is decided by the SEC. The SEC has thus set forth the conditions under which an offer is not held to be public and under which an international securities issue is not subject to its jurisdiction. The corresponding rules can be found in the SEC's Regulations D[83] and S.[84]

US rules and regulations affecting private placements

Principal rule: registration

Section 5, which is the heart of the Securities Act 1933, provides that no offer may be made to the public unless a registration statement has been filed with the SEC or the offer is exempt, and that no sales of securities may be made until the registration on file with the SEC has been declared effective. Section 4(2) of the Securities Act 1933 exempts from registration offers and sales by an issuer not involving a public

68. Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (4th edn, New York, 2004), p.1.
69. Then in place in New York.
70. Based loosely on the then-in-force UK Companies Act.
71. Berman, fn.67 above, pp.2 *et seq.*; Loss and Seligman, fn.68 above, pp.32 *et seq.*; Hal S. Scott, ''Federal Regulation of Securities'', in Alain B. Morrison, ed., *Fundamentals of American Law* (Oxford, 1996), p.591; Hazen, fn.67 above, p.7; Yasmine Ergas and Ira A. Greenstein, ''Securities Disclosure Requirements in the United States'', in William G. Horton and Gerhard Wegen, eds, *Litigation Issues in the Distribution of Securities: An International Perspective* (London, 1997), p.9.
72. See Federal Securities Act 1933.
73. Daeniker, fn.3 above, pp.67 *et seq.*
74. It provides for the disclosure and registration of securities distributions and exemptions from registration.
75. This Act covers exchanges and OTC markets, brokers and dealers, insider dealing, trading and sales practices, capital adequacy and consumer protection, purchases of securities on credit, periodic reporting requirements, proxy regulation and issuer and third party tender offers.
76. For the establishment of public utility holding companies.
77. This law governs public offers of debt (bonds and debentures).
78. Under this Act, investment companies register shares for offers and the SEC governs aspects of investment company structure and management.
79. It regulates investment advisers. See Scott, fn.71 above, pp.586 *et seq.*
80. Hazen, fn.67 above, p.9; Hal S. Scott and Philip A. Wellons, *International Securities Regulation* (New York, 2002), p.23; Berman, fn.67 above, p.3.
81. Scott, fn.71 above, pp.588 *et seq.*
82. Ergas and Greenstein, fn.71 above, p.9; Berman, fn.67 above, p.4.
83. 17 C.F.R. s.230.501–508.
84. 17 C.F.R. s.230.901–905; Daeniker, fn.3 above, p.68.

offering and is, thus, the "classic" private placement exemption. Regulation D (comprising Rules 501–508) under the Securities Act 1933 is a set of "safe harbour" provisions under which an issuer is deemed to have satisfied s.4(2) for private offerings (Rule 506) (or s.3(b) for small offerings (Rules 504 and 505)).[85]

Any private placement must be qualified at both state and federal levels. The patchwork of differing state securities laws can make compliance complex. However, state securities laws concerning Rule 506 offerings that conflict with federal law generally have been pre-empted. Nevertheless, for Rule 506 offerings, states may require notice filings and payment of fees.[86]

Exemptions

General

In practice, issuers offer and sell securities without registration under the Securities Act 1933 and may do so by conducting private placements of those securities in reliance on exemptions from registration afforded by ss.3 and 4 of the Securities Act 1933.[87] Both the s.3 and s.4 exemptions dispense with the Securities Act 1933's registration requirements, but they do not prevent potential liability under the anti-fraud provisions contained in s.12(2) and (17)(a).[88]

The burden of proof for establishing any of the exemptions lies with the person claiming an exemption. A corollary to the burden of proof and persuasion resting with the person seeking to establish the availability of the exemption is the fact that exemptions are to be strictly construed.[89] Because of the strict construction and burden of proof, transactions must be carefully structured and documented in order to be sure of securing an exemption.[90]

In addition to the general advantages of private placements set forth above,[91] the US provides a few more. First, the issuer in a private placement has greater control over the timing of the issuance of the securities than it would if it were subject to the SEC registration process, primarily due to the absence of the need for SEC staff review of the offering document. Secondly, unlike an issuer in a registered public offering, a private placement issuer generally does not become subject to costly, continuing obligation requirements. Finally, an issuer which is not subject to continuing obligations and which conducts a private placement generally will avoid becoming subject to the corporate governance and other requirements of the Sarbanes-Oxley Act 2002.[92]

However, as described in greater detail below, US private placements made in reliance on s.4(2) of the Securities Act 1933 or Regulations D and S also have a number of disadvantages. For example, private placements are subject to various limitations, such as restrictions relating to the number and nature of offerees and the manner in which the offering may be made, and the securities received in such private placements are "restricted securities" for purposes of resale in the United States under Rule 144, Rule 144A and Regulation S of the Securities Act 1933.[93]

Section 4(2) exemption

Section 4(2) of the Securities Act 1933, commonly referred to as the "private placement exemption",[94] provides an exemption from registration under s.5 for 2 transactions by an issuer not involving any public offering". The Securities Act 1933 does not define the phrase "public offering" and, as a result, the conditions required to ensure that an offer complies with s.4(2) have been developed via a mixture of case law and market practice.[95] The factors considered for a valid private placement under s.4(2) are based on fact and include the following[96]:

(i) number (limited in size) and character of offerees (level of sophistication);
(ii) character of offering (nature and minimum size of offering);
(iii) availability of information (comparable to the registration statement);
(iv) manner of offering (no general advertising or solicitation);
(v) absence of redistribution ("investment" intent of purchasers); and
(vi) beware of integration (if the offerings are made close in time to another).

Generally, most practitioners also look to Rule 506 as a guide for a valid s.4(2) exemption.[97]

Regulation D

Regulation D is a non-exclusive safe harbour from s.5. Hence, if an offering fails to comply with the specific conditions of Regulation D, then a s.4(2) exemption may still be available. Regulation D contains three different exemptions: Rules 504 and 505 provide exemptions for certain small offerings under s.3(b) of

85. Guy P. Lander, "A Primer on Private Placements and Achieving Liquidity in Cross-Border Offerings", in *100 Women in Hedge Funds*, vol.4(1), pp.45–55, p.45; Hazen, fn.67 above, pp.4 *et seq.*; Steinberg, fn.67 above, p.31.
86. Lander, fn.85 above, p.49; Steinberg, fn.67 above, p.35; Edward F. Greene *et al.*, *U.S. Regulation of the International Securities and Derivatives Markets* (New York, 2002), para.4.07.
87. Scott, fn.71 above, p.588.
88. See p.262 below. Hazen, fn.67 above, p.164.
89. See, e.g. *SEC v Murphy*, 626 F.2d 633 (9th Cir.1980).
90. Hazen, fn.67 above, p.165.
91. See [2006] J.I.B.L.R. 214.
92. Lander, fn.85 above, p.45; Berman, fn.67 above, p.57.
93. Berman, fn.67 above, p.57. See p.260 *et seq.* below.
94. Hazen, fn.67 above, p.224.
95. Scott, fn.71 above, pp.594 *et seq.*; Steinberg, fn.67 above, p.37; Scott and Wellons, fn.80 above, p.27, Greene *et al.*, fn.86 above, para.4.02[1].
96. According to the leading case *SEC v Ralston Purina* 346 U.S. 119 (1953).
97. Lander, fn.85 above, pp.45 *et seq.*; Greene *et al.*, fn.86 above, para.4.01.

the Securities Act 1933, limited to $1 and $5 million, respectively, during any 12-month period and Rule 506 provides a safe harbour under s.4(2) without any limitation as to the amount of the offering.[98] In addition to the specific conditions described below, there are general conditions that must be met in each case, such as the ''Beware of Integration'' rule (i.e. offerings of the same securities made too closely together in time may be deemed to constitute one combined offering), the compulsory filing of notice of sale on form D and substantial compliance with Regulation D (Rule 508).[99]

(a) Rule 506

Rule 506 allows an issuer to sell an unlimited amount of its securities to an unlimited number of accredited investors and to 35 non-accredited investors. The conditions to be met under Rule 506 are:

(i) 35 non-accredited,[1] but sophisticated investors[2];
(ii) sufficient information, depending on the character of the investor[3];
(iii) no general advertising or solicitation; and
(iv) beware of resale restrictions.[4]

Rule 506 allows for the issuance and sale of securities to an unlimited number of purchasers (selected from an unlimited list of offerees) if they qualify as accredited investors. In what might appear to be a perverse technical loophole of the law, it is not a breach of Regulation D if the placement is made available to an unlimited number of offerees. Given a large pool of ''wealthy individuals'' and a revised prospect list, an issuer can make what amounts to a public offering—with perhaps as many as 1,000 or more purchasers of the security and some multiple of that number as offerees—without technically breaching Regulation D.[5]

However, this interpretation should be read in light of (iii) above, i.e. regardless of the number of purchasers (maybe even none) or offerees, if the placement is made on the basis of either ''general solicitation'' or ''general advertising'', then an unregistered public offering may have occurred. The first rule of thumb is to keep careful records. Secondly, any advertising using any media such as the newspaper, radio, television and so forth would be considered an announcement and would be construed as a ''general'' solicitation.[6] And as a practical matter, it is unlikely that a founder doing his first, and perhaps only deal of his lifetime would have access to such a large list of pre-existing relationships. Absent such a list, the founder is left to soliciting his friends, business acquaintances, and parties with whom he can establish a prior relationship of some kind.[7]

(b) Rule 505

Rule 505 permits an issuer to sell securities with an aggregate offering price of up to $5 million in a 12-month period. To take advantage of this provision, the following conditions must be met:

(i) no more than 35 non-accredited investors, however sophisticated they are;
(ii) the issuer must not be disqualified under the provisions of Rule 262; and
(iii) the same conditions apply as under Rule 506 as regards information furnished to purchasers and the absence of general solicitation.

The conditions for availability of a Rule 505 exemption are very similar to those of a Rule 506 exemption. However, since Rule 506 is an exemption under s.4(2), it pre-empts state securities regulations to a large extent, while Rule 505 does not. Consequently, there is no reason to use Rule 505 when Rule 506 is also available.[8]

(c) Rule 504

Rule 504 permits an issuer not subject to the Securities Exchange Act 1934 reporting requirements to sell securities with an aggregate offering price of

98. Loss and Seligman, fn.68 above, pp.402 *et seq.*; Lander, fn.85 above, p.46, Hazen, fn.67 above, pp.207 *et seq.*

99. For further details, not of particular interest for the given topic, see Lander, fn.85 above, p.48, Steinberg, fn.67 above, pp.40 *et seq.*, Greene *et al.*, fn.86 above, para.4.02[2]; YiLin Wu, *The Choice between Public and Private Equity Offerings*, pp.6 *et seq.*, available from *http://papers.ssrn.com*.

1. Accredited investors include, in relevant parts: financial institutions, such as banks or insurance companies, other financial institutions, senior staff of the issuer, entities with assets over $5 million and high net worth individuals (net assets of over $1 million or income greater than $200,000 for the last two years, or together with spouse, in excess of $300,000, and reasonable expectation of the same in the current year).

2. Each purchaser must have such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment, or the issuer must reasonably believe this to be the case. Note that under Regulation D only purchasers, as apposed to offerees under s.4(2), must meet the sophistication test.

3. To accredited investors: no specific information need be furnished. To non-accredited investors: see Rule 502 lit. b para. 2. The anti-fraud provisions of Rule 10b-5 apply to all offerings. See p.262 below.

4. The issuer is required to exercise reasonable care to ensure that the purchasers of the securities are not underwriters (as defined in s.2(11) of the Securities Act 1933).

5. VC Experts, *Private Placement Memorandum and Regulation D*, p.2, available from *www.vcexperts.com*.

6. The SEC considers that general solicitation does not occur when the solicitor and his targets have a nexus: as SEC puts it, a ''substantial pre-existing'' relationship.

7. VC Experts, fn.5 above, pp.2 *et seq.* Presumably, that list can be expanded vicariously, by asking the founder's lawyer, accountant, and/or banker to make the material available to potential purchasers with whom they are acquainted. How much further he or she can go is unclear. Parenthetically, as was earlier indicated, it is critical to keep careful records identifying all offerees, even though the names do not appear on a master mailing list. If an intermediary is asked to help, it is important to keep a record of the intermediary's activities.

8. Lander, fn.85 above, p.47.

up to $1 million in a 12-month period. However, the $1 million limit is reduced by any other sales made in reliance on exemptions under Rule 505. The same conditions as under Rule 506 apply to the absence of general advertising or general solicitation. There are no specific requirements for information provided to offerees.[9] Most importantly, however, is the fact that securities issued in a Rule 504 transaction are no longer ''restricted'' securities.[10]

Regulation S

This regulation (Securities Act 1933, Rules 901–905) provides a non-exclusive safe harbour for so-called offshore distributions (and resales) of securities of US and foreign issuers.[11] If the conditions of Regulation S are met, the securities do not have to be registered with the SEC under the Securities Act 1933.[12]

The provisions of Regulation S relating to offshore distributions of securities (the ''issuer safe harbour'') distinguish between overseas directed offerings and other offerings. An overseas-directed offering of securities into a single country is made in accordance with the local laws and customary practices in this country. Thus, under Regulation S, a private placement directed exclusively to Swiss investors only qualifies as an overseas directed offering. Offerings are not subject to registration under the Securities Act 1933 if the offer was made in a offshore transaction[13] and, cumulatively, the issuer, the distributor of securities and all of their affiliates must not make any directed selling efforts in the United States during a specified period of time.[14]

Consequences of non-registration: resale restrictions

General

Regulation D was intended to provide certainty of the availability of the issuer's exemption, but it did not address the availability of an exemption for resales of securities acquired by investors in a private placement. Securities issued in a private placement are characterised as ''restricted securities'' and can be resold in the United States, inter alia, under Rule 144, Rule 144A (the so-called ''Section 4($1\frac{1}{2}$)''), Regulation S or a registration statement.[15]

Rule 144

Rule 144, as a (non-exclusive) safe harbour under s.4(1) of the Securities Act 1933, provides an exemption from registration for resales by someone other than the issuer, underwriter or dealer. It offers holders of restricted securities the right to sell these securities in brokers' transactions (rather than by means of a private placement or registered offer) in an amount up to the greater of 1 per cent of the outstanding amount of securities of that class or the average weekly trading volume in such securities in the preceding four weeks, provided, however, that there is current information publicly available.[16] In addition, the holder is required to have held the securities for at least one year from the time of their purchase from the issuer to the date of their resale by the holder or subsequent holder.[17]

Alternatively, a holder may in most cases sell the restricted securities of that issuer free of any Rule 144 requirements if two years elapse between the purchase and its resale in the public markets.[18] However, for many securities there is no public trading market in the United States, and the volume limitations and holding period requirements make reselling a large block of securities extremely expensive. These problems are most severe where institutional portfolios are concerned.[19]

Rule 144A

In response to this problem, the action taken by the SEC in approving Rule 144A on April 19, 1990 along with the adoption of Regulation S, provided a basis for enhanced efficiency and liquidity in the multi-billion-dollar private placement market. Rule 144A provides a (non-exclusive) safe harbour from registration under s.4(1) and (3) of the Securities Act 1933 for resales of certain restricted securities by persons other than the issuer to qualified institutional buyers.[20] Less technically, Rule 144A allows financial institutions with more than $100 million invested in securities to trade unregistered privately placed securities freely among themselves. According to Scott, Rule 144A is an ''attempt to create a kind of 'free-trading zone' ''.[21] Furthermore, broker-dealers with at least $10 million in proprietary positions and assets under management may also participate in

9. John A. Eckstein, *Private Placements: Exemption and Disclosure Issues*, pp.2 *et seq.*, available from *www.fwlaw.com*; Lander, fn.85 above, pp.47 *et seq.*
10. See below.
11. Loss and Seligman, fn.68 above, p.219.
12. Daeniker, fn.3 above, p.68; Steinberg, fn.67 above, pp.67 *et seq.*; Scott and Wellons, fn.80 above, pp.58 *et seq.*; Greene *et al.*, fn.86 above, para.4.03[2]; Wu, fn.99 above, pp.7 *et seq.*
13. To qualify as an offshore transaction, the offer may not be made to a person in the US. In addition, the buyer must be located outside the US, or the sale must have been executed through a foreign organised securities market, unless the seller knows that the transaction has been pre-arranged with a buyer in the US (17 C.F. R. s.230.903(a)).
14. i.e. any activity undertaken for the purpose, or expected to have the effect, of conditioning the market in the US (17 C.F.R. s.230.903(b)).
15. Lander, fn.85 above, p.49; Greene *et al.*, fn.86 above, para.4.01.
16. Scott, fn.71 above, p.596; Hazen, fn.67 above, pp.258 *et seq.*
17. Steinberg, fn.67 above, pp.132 *et seq.*; Greene *et al.*, fn.86 above, para.4.02[3].
18. Loss and Seligman, fn.68 above, pp.430 *et seq.*; Berman, fn.67 above, p.89.
19. Scott, fn.71 above, p.596.
20. Lander, fn.85 above, p.50.
21. Scott, fn.71 above, p.596. See also Greene *et al.*, fn.86 above, para.4.03.

such transactions. Hence, Rule 144A increases the private placement market liquidity, thereby lowering the cost of capital to issuers by reducing the discount which would otherwise have to be offered to private investors.[22]

Regulation S

Regulation S provides for a further resale safe harbour. Rule 904 states the circumstances under which a resale of securities is deemed to occur outside the United States (and, therefore, is not subject to the requirements of US securities regulation). As a general rule, an offer or sale made in an offshore transaction which does not involve directed selling efforts in the United States is covered by this exemption.[23]

Section 4(1½)

This is an exemption established under market practice and confirmed by leading US securities law practitioners under s.4(1). Private resales of restricted securities outside Rule 144 (i.e. outside the public markets during the Rule 144 one-year holding period or longer) are fairly common. Generally, the SEC has not objected when one private placement investor holding restricted securities has privately negotiated and sold those securities to another, if the buyer has agreed to hold them subject to the same restrictions as those that bind the seller. These private resales are structured similar to a s.4(2) private placement, but cannot rely on s.4(2) since that applies only to transactions by an issuer. This bar-created exemption for private resales based on s.4(1) with s.4(2) procedures is called s.4(1½).[24] Although not expressly contained in the statute nor formally adopted by the SEC, support for the so-called s.4(1½) exemption can be found in the SEC "no action letters", interpretative releases, the courts' decisions, and the commentators' writings.[25]

Registration under the Securities Act 1933

If an exemption under the Securities Act 1933 is not available for the resale of securities by an affiliate of an issuer or by a person holding restricted securities, such securities must be registered under the Securities Act 1933, by Form S-1, S-3, S-4, F-1, F-3 or F-4 or the new WKSI rules.[26]

Financial promotion: investment advisers, brokers and dealers

Financial promotion which may be defined as providing information on investments to potential investors includes a number of regulations including the Investment Advisers Act of 1940, broker and dealer definitions under the 1934 Securities Act, the self-regulatory rules of the National Association of Securities Dealers ("NASD") and state laws. The Investment Advisers Act[27] regulates the activities of certain "investment advisers," which are defined in s.202(a)(11) as persons who receive compensation for providing advice about securities as part of their regular business.[28] Section 202(a)(11)(C) of the Advisers Act provides an exception to this definition of investment adviser for any broker or dealer "whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor".[29] This exception "amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business".[30] The Investment Adviser Act, s.206 makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, to employ any device or to engage in any act which is fraudulent or manipulative. Pursuant to authority granted under s.206, the SEC has required that investment advisers comply with various advertising standards (for example as to historical investment performance).[31]

A very broad definition of a broker is found in the 1934 Securities Act which includes "any person engaged in the business of effecting transactions in

22. LeRoy D. Brooks, Eurico J. Ferreira and Joseph T. Harder, "Private Equity Offerings: Picking Bad versus Good Performers", *The Journal of Private Equity*, Summer 2002, p.57; Loss and Seligman, fn.68 above, pp.434 *et seq.*; Steinberg, fn.67 above, pp.146 *et seq.*

23. 17 C.F.R. 230.904; Daeniker, fn.3 above, p.70; Steinberg, fn.67 above, pp.67 *et seq.*; Scott and Wellons, fn.80 above, pp.58 *et seq.*

24. Hazen, fn.67 above, pp.267 *et seq.*; Lander, fn.85 above, pp.49 *et seq.*

25. Steinberg, fn.67 above, pp.144 *et seq.*; Hazen, fn.67 above, p.269; Greene *et al.*, fn.86 above, para.4.01.

26. Lander, fn.85 above, p.50. The new "WKSI" rules implement a new set of rules with greater freedom in terms of offering materials for certain offerings by "well-known issuers". They came into effect in December 2005.

27. Codified under 15 U.S.C. 80b.

28. More specifically, under 15 U.S.C. 80b-2, an "investment adviser" is defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities".

29. For a discussion of the scope of the Advisers Act, see *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Release No.1092 (October 8, 1987) [52 FR 38400 (October 16, 1987)] ("Advisers Act Release No.1092").

30. See *Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940*, Investment Advisers Act Release No.2 (October 28, 1940) [11 FR 10996 (September 27, 1946)] ("Advisers Act Release No.2").

31. Freshfields Bruckhaus Deringer, "International Survey of Financial Markets Law and Regulation—United Kingdom" (2001) J.I.F.M. Supp (special issue) 122–134, p.433.

securities for the account of others''.[32] Whilst this broad definition apparently overlaps with the concept of an investment adviser under the Investment Adviser Act, subsequent case law, SEC regulation, and NASD rules have established a body of guidance on broker's activities, including commissions, notice that they must provide, due diligence requirements, and non-disclosure of material non-public information.

It is important to note that any broker or dealer is exempted from liability for providing such advice under the Investment Advisers Act so long as this service is ''solely incidental to the conduct of his business . . . and who receives no special compensation therefor''.[33] However, leaving aside the particularities of state law, the NASD fills the gap of regulating on a national sectoral basis[34] the communications of brokers including sales literature[35] NASD also provides specific guidance on ensuring that communications to the public are not misleading, requiring brokers to take due consideration in their communications with the public of balancing the risks and potential benefits as well as maintaining a sensitivity to the level of audience and the possibility that the communication may reach ''larger or different audience(s) than the one initially targeted''.[36]

Liability

Liability under the US securities laws exists for untrue statements of material fact, inter alia, in an offering circular, such as a private placement memorandum. Liability arises if material information is omitted or if materially misleading information is included (s.12 lit. a and 17 of the Securities Act; s.10 of the Securities Exchange Act 1934 and Rule 10b-5 thereunder). While the standard for civil liability for omissions is similar in public and private offerings, the scope of disclosure is fixed in the case of public offerings not only by these liability provisions but also, as the text notes, by detailed SEC rules mandating the scope of disclosure.

The most far-reaching provision regarding fraud, however, is Rule 10b-5 under the Securities Exchange Act 1934, which establishes liability for acts essentially identical to those prohibited by s.17(a) but extends such liability to cover purchases as well as sales of securities.[37] Hence, the issuer, and any parties acting for the issuer, must take all reasonable steps to ensure that the information given to the offerees and purchasers is complete and accurate. All information passed on in the course of the private placement, either orally or by memorandum (or offering circular), is subject to the anti-fraud provisions of the federal securities laws. The fact that the offering memorandum is not reviewed by the SEC does not lower the standards for accuracy which would be applicable to any registered offering. Sellers in private placements may also be subject to liability under state securities laws and the common law, but these potential remedies are less likely to provide fertile ground for the nationwide class actions that have marked securities law litigation under the federal securities laws.[38]

Summary

As in the European Union and the United Kingdom, the United States implemented a fairly broad definition of public offers (''no offer may be made to the public without registration or exemption'').[39] As a consequence, a registration statement must be filed unless the offer is exempt (ss.3 and 4 of the Securities Act 1933 provide for an abundance of exemptions). However, Regulation D, a non-exclusive safe harbour for limited offers or offers to accredited investors, plays a pivotal role for private placements within the United States, and Regulation S, plays the same role for offshore distributions.

Regardless of how one might meet the various requirements of s.4(2) of the Securities Act 1933, Rules 501–508 or 901–905, there is one major drawback to privately placed securities, i.e. resale restrictions. According to US legislation, securities acquired through an exemption regulation can only be resold in the United States under fairly onerous conditions. Chief among these are that the holding duration of the shares must be greater than one year, or these must be on resale to qualified institutional buyers, resale to a party outside the United States, private resales or a subsequent registration of the securities. As with the registration exemptions, the Securities Act 1933 and its affiliate rules and regulations provide for a dense legislative network to work through if one decides to resell one's shares.

Regarding financial promotion and investment advice, the former is regulated by the Securities Act 1933 (no general solicitation or any public

32. See Securities Act 1934, s.3(a)(4), codified at 15 U.S.C. s.78c(a)(4).

33. Investment Advisers Act 1940, s.202(a)(2)(C); 15 U.S.C.s.80b-2(C).

34. According the NASD website, the NASD oversees the activities of more than 5,100 brokerage firms, approximately 109,300 branch offices and more than 657,690 registered securities representatives.

35. See NASD Manual, s.2210(a)(2) which defines ''Sales Literature'' as ''[a]ny written or electronic communication, other than an advertisement, independently prepared reprint, institutional sales material and correspondence, that is generally distributed or made generally available to customers or the public, including circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, reprints (that are not independently prepared reprints) or excerpts of any other advertisement, sales literature or published article, and press releases concerning a member's products or services''.

36. See NASD Manual IM-2210-1(2), ''Guidelines to Ensure That Communications With the Public Are Not Misleading''.

37. Ergas and Greenstein, fn.71 above, p.18.

38. Greene *et al.*, fn.86 above, para.4.04[2].

39. See Securities Act 1933, s.5.

advertisement), whereas the latter is restricted by the Investment Adviser Act 1940. Section 206 of this Act makes it unlawful for any investment adviser to employ or devise or to engage in any act which is fraudulent and manipulative.

In terms of the intensity of regulatory scrutiny, it is not improvident to say that the United States' sophisticated system of imposing civil and criminal liability for omissions of material information and for materially misleading information is perhaps the most onerous in the world.

Similarities and distinctions amongst the four regimes

The task of comparing four different private equity-placement regimes on two continents is complicated by their unique respective historical backgrounds and two distinct legal systems. None of the regimes closely matches that of another. However, if we use a thematic approach as stated in the beginning of this paper,[40] then we may compare and contrast four major factors of each regulation. The factors are: (i) the definition of a private placement; (ii) the regulation of the participants (issuer, intermediaries and purchasers); (iii) the regulation of the transaction (disclosure requirements, financial promotion restrictions and liability rules); and (iv) resale restrictions. These four factors constitute a logical framework with which we can assess the contextual differences between the regimes.

In addition, the US regime, being the oldest, most burdensome and best tested of the four jurisdictions, shall serve as a benchmark and hence, as a starting point for comparison and contrast. Each of the four factors will be examined under the US legal system first, and then against each of the other jurisdictions.

Similarities

Not surprisingly, there are not many similarities between the US and the three other regimes. However, two of the factors, namely, the definition of a private placement and the liability regime, appear to have some common ground in all four regimes.

Strictly speaking, there is no positive definition of private placements common to all four jurisdictions. Instead, the four jurisdictions define public rather than private offerings, and hence specify private placements via a negative circumscription only. In essence, a public offer comes in all the multi-various forms of communications by any and all means from the issuer and its authorised agents to persons with the intention of enabling an investor to decide on a subscription for specified securities.[41]

40. See [2006] J.I.B.L.R. 217.

41. See [2006] J.I.B.L.R. 218 and 223, as well as pp.254 and 257 above.

When it comes to the exceptions of public offerings, which in turn define private placements, each jurisdiction follows its own set of idiosyncratic rules. In the United States, for example, thanks to some specific exemptions in the Securities Act 1933, shares can be offered to an unlimited number of ''accredited investors'' (that is, an investor with a certain knowledge and with an appropriate financial background) and, in addition, to a maximum of 35 non-accredited (but sophisticated) investors, whereas in the European Union, they could also be offered to an indefinite number of ''qualified investors'' (which is the same as an ''accredited investor'' in the United States) and, in addition, to 100 non-qualified investors in each Member State. In other words, while in the United States an unlimited number of accredited investors and a maximum of 35 non-accredited (but sophisticated) investors can be approached, the same transaction in EU Member States could be executed by aiming at an unlimited number of qualified investors and a maximum of 2,475[42] non-qualified (and non-sophisticated) investors.[43] In sharp contrast, Switzerland has not implemented any particular exemptions at all, save stating that an offer is not meant to be public if it is addressed to a limited group of persons.[44]

The other similar factor in the three non-Swiss jurisdictions is the liability regime. It is important to note that the European Union allows Member States discretion to establish state-of-the-art liability regimes. All four jurisdictions have provided civil and criminal sanctions, with the United States, acting through its independent agency, the SEC, exhibiting the most efficient enforcement mechanisms.

Distinctions

Regarding the other factors, that is, the regulation of participants, transactions and resale, each country has a different approach, and its own particular patchwork of state regulation. The United States, having the most carefully regulated securities regime, has the most sophisticated private placement law in the world.

The United States not only regulates all the intermediary companies and firms (Investment Adviser Act 1940),[45] but also the financial promotion of a private placement in the Securities Act 1933 (i.e. no general solicitation nor any public advertisement).

42. This mathematical flourish comes from multiplying 25 Member States by 99 (100–1).

43. Except this is still subject to some country-specific requirements to protect genuinely unsophisticated retail investors—it is thus not legitimate to make a private offer to 100 private investors in France.

44. With hardly any case law giving the provision more shape. Some commentators suggest the numerical threshold to be at 20 potential investors and up.

45. s.206 of this Act makes it unlawful for any investment adviser to employ or devise or to engage in any act which is fraudulent and manipulative.

Whilst these two concepts were copied in other countries, two other regulations are still unrivalled: the disclosure and filing of a private placement according to Regulation D with the SEC on the EDGAR database and the so-called resale restrictions. According to the US legislation, securities acquired through an exemption can only be resold under fairly specific conditions. As with the registration exemptions, the Securities Act 1933 and its affiliate rules and regulations provide for a dense legislative network to work through if one decides to resell one's shares.

While comparisons are often made between the EU and the US regimes, EU securities regulation is an entirely different creature from the highly sophisticated US federal securities regulation regime. Among the EU securities regulation's distinctive characteristics are the relative immaturity of the EU regime as compared to its US counterpart, its root in market integration rather than in the traditional objectives of securities regulation, and the absence in the EU regime of a powerful central regulatory authority on the lines of the SEC.[46] It does, however, share one feature with its US counterpart: as in the US regime, investment advice is heavily regulated in the European Union. However, financial promotion as such is hardly touched upon.

The United Kingdom appears to be gaining ground on the United States in terms of regulating private placements. Since the Labour Party took over office in 1997, financial promotion and investment advice have been, inter alia, regulated to an unprecedented and unrivalled extent. The comprehensive Financial Services and Markets Act 2000 in accordance with the Financial Promotion Order 2001 set the tone, and the former ordered all financial players in the United Kingdom to become authorised. Subsequently, the FSA supervises all the previously authorised firms under strict scrutiny. As regards financial promotion, the Financial Promotion Order 2001 covers all means of communication in a media-neutral manner.

Switzerland, finally, is definitely the least regulated country amongst the four jurisdictions under review. The fact is that Swiss law regulates private placements by a mere two provisions.[47] Therefore, it has no rules concerning restrictions on oral communication (both solicited and unsolicited),[48] no advertisement restrictions (save investment funds), no intermediary regulations (subject to certain industries being regulated due to their principal business, such as banks, insurance companies and pension funds), no resale restrictions and no disclosure or filing requirements. In other words, neither asset managers nor financial advisers giving advice to their customers, nor the promotion and marketing of the documents themselves, are prohibited, supervised or regulated under Swiss law.

46. Niamh Moloney, *EC Securities Regulation* (Oxford, 2002), p.53.

47. Art.652a CO (issuance of a prospectus) and Art.752 CO (prospectus liability).

48. Except for aggressive sales techniques which can give rise to civil and criminal liability (Secretan Troyanov, "International Survey of Financial Markets Law and Regulation: Switzerland" (2001) J.I.F.M. Supp (Special Issue) 379).

Summary and conclusion

Due to the volatility and disasters that periodically appear in the market, it has become a social axiom that the financial markets require regulation to protect investors. On this basis, the EU and US regulators have isolated a number of key areas they wish to supervise. Such areas include the authorisation of participants, the imposition of financial promotion restriction and the prevention of market misdemeanours. From a broad perspective, these catch-all provisions are in place to meet the pro-market primary goals of ensuring that the markets continue to operate with confidence and stability.[49] Whilst the latter goal may be difficult to enforce because of the volatile nature of the markets, the notion of market confidence means that market participants can rely on a consistent set of rules which, on balance, protect investors rather than harm them.

In the name of investor protection, however, the United States is prone to legislate beyond the common minimal standard, and it has introduced the concept of resales restrictions and the disclosure and filing of private placement information. These appear unnecessarily burdensome from an investor protection perspective. In contrast, Switzerland does not appear to support any minimal international standard of regulation for private equity issues. Its regulation of public offerings of securities and its private and its public liability regime are far less onerous than the United States and to some degree less onerous than the United Kingdom and the European Union. When it comes to the regulation of the participants (intermediary supervision), the transaction regulation (disclosure, filing and financial promotion) and the resale restrictions, the Swiss federal law-maker has so far been silent.

We return to the original question of which legal concepts might be helpful to improve the Swiss private placement regime. We suggest that the Swiss federal law-maker needs to balance the interests of investor protection against a slim, liberal, cost-effective and enforcement-efficient private placement regime. It would be imprudent blindly to apply a copy-and-paste approach since this could have a detrimental impact on the competitive advantage which the Swiss enjoy, at least from the standpoint of regulatory burden. We recommend the following actions for the Swiss law-maker.

First, Art. 652a CO, since it shows a fair number of weaknesses, should be amended. It does not draw a clear distinction between public offerings (requiring a prospectus) and private placements (no requirement, but often an offering memorandum is drawn up for

49. Mistry, fn.46 above, p.137.

marketing purposes). A change to the ''general rule and exception approach'', as we have seen it in all other three surveyed jurisdictions, constitutes a practicable and easy way to solve this problem. In addition, secondary distributions are not caught by the provision, nor are international offerings into Switzerland. When revising Art.652a CO, the Swiss law-maker would be well advised to fill in these gaps which deprive the market of a minimal regulatory certainty.

Switzerland has also failed so far to set out complete regulations either in terms of market participants or transactions. In our view, however, it would not be efficient or effective to regulate both. Since these regulatory schemas overlap, and hence cause an enormous financial burden for young, money-seeking companies, one should decide to establish one approach or the other (like the European Union, but not the United Kingdom or the United States). Being in the privileged position of choosing which approach to follow, Switzerland will most certainly follow a participant-based approach to regulation, paying particular attention to the regulation of intermediaries, in particular to independent asset managers, introducing brokers as well as to currency dealers, since the Swiss people voted about a decade ago against such a Financial Services Bill. In February 2005, an expert panel commissioned by the Swiss Finance Ministry recommended (i) taking immediate action for the prudential supervision of independent mutual fund managers, since EU legislation requests them to be authorised and supervised, and (ii) that the Swiss Government should decide whether all other asset managers, introducing brokers and currency dealers shall be supervised in accordance with EU legislation in the future. Since a greater interest in Swiss markets has developed over the years, and with Swiss private equity and venture capital industry requests for it,[50] there is some chance that the Bill will be—at least partially—revived and passed in the not too distant future.

Strong disclosure and filing requirements, as well as the resale restrictions, are brilliant concepts for mature markets such as in the United States. However, given that the Swiss market for private equity and venture capital is relatively nascent and comparatively negligible on a European scale, it would not make sense to take the lead with respect to these matters, before the European Union or some other Member State fully introduces and tests these concepts.

As a result of the relatively long-term nature of private equity investing, one should bear in mind that factors other than a stringent legal environment are important for young entrepreneurial firms. Amongst others, political stability and a sympathetic fiscal environment are necessary conditions for successful long-term investments. Low rates of taxation on business income, and capital gains exemptions or, at least, low rates of taxation improve the prospects of achieving a satisfactory return. Stable tax rates enable expected returns to be calculated with greater confidence. Last but not least, it is of paramount importance to rely on a state-of-the-art capital market as regards initial public offerings, still the preferred exit route for venture capitalists.[51] These factors, together with a legal regime sympathetic to the entrepreneurial firms are likely to stimulate the demand for private placements in any jurisdiction in the future.

50. For competition reasons: customer nowadays demand a (state) authorisation for their business partners.
51. Simon Harris and Chris Bovaird, *Enterprising Capital: Study of enterprise development and the institutions which finance it* (Hants, 1996), p.40.