ERSKINE WOOD SR. CHAIR INSTALLATION LECTURE

FLEECING GRANDMA: A REGULATORY PONZI SCHEME

by
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This Article examines the regulatory failure that allowed Medical Capital to engage in a Ponzi scheme to market over $2 billion in promissory notes as private placements. Utilizing a vast stockbroker network, Medical Capital sold the notes to more than 20,000 retail investors including vulnerable senior citizens. The Article explains how in spite of many warning signs, none of the potential gatekeepers, including the SEC, FINRA, the stockbrokers, the banks, the attorneys, or the independent due diligence analyst interceded to protect the investors.

Under current SEC rules, issuers can sell any dollar amount of private placement securities to an unlimited number of defined accredited investors with virtually no governmental oversight. The Article recommends that in line with its authority under the Dodd–Frank Act, the Commission tighten the standards for accredited investor status. The Article further argues that, coupled with untethered stockbroker activity, the current regulatory structure unduly favors small business at the expense of retail investors. This problem will be exacerbated by the 2012 JOBS Act, which mandates looser advertising rules for Rule 506 private placements. The Medical Capital fraud suggests that Congress and the SEC are misguided in their heavy reliance upon stockbrokers as effective intermediaries. The Article concludes with a modest proposal to rein in the activities of the brokers.

Good evening. I would like to thank President Glassner, Dean Klonoff, and Professor Huffman for their kind introductions and to once

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again thank the Wood family for their generosity. I am very, very honored to follow in the steps of Jim Huffman and become the second holder of the Erskine Wood Senior Chair.

My lecture tonight is entitled *Fleecing Grandma: A Regulatory Ponzi Scheme*. While my presentation is called a lecture, it is really more of a story: I want to talk to you tonight about a multi-billion dollar problem. First, however, I must begin with a confession. I may have enticed you here under false pretenses. For you see, I work in the trenches in the field of securities regulation—a mysterious and fascinating world of extreme interest to only a handful of you in this audience. But Grandma—everyone loves Grandma—and no one wants Grandma to get fleeced. That would be like hurting a puppy.

So now my confession: my talk tonight is not just about Grandma. Grandma is a placeholder, albeit a sweet one. Grandma, you will see, includes Grandpa, other seniors, working professionals (especially, it seems, doctors and dentists), other folks who have worked their whole lives and hope to retire someday, social security recipients, and those living on pensions. In short, Grandma represents all retail investors.

In my world, when we say "retail investors" we mean "people" as opposed to institutions such as pension plans or insurance companies. So tonight I am going to talk about the plight of Grandma and all retail investors in the unregulated world of private placements. Using Grandma as bait, I have lured you here to share in my technical world. My goal is to convince you that Grandma, and her money, are in need of protection, and that while the Greek debt crisis grabs the headlines, our regulators need to step up and pay some attention to Grandma.

On one hand, my task should prove easy. After all, Congress passed the first federal securities laws in the aftermath of the Great Depression (the last one, the 1929 depression) to protect Grandma and other retail investors.[1] These federal statutes and the thousands of pages of rules based upon them, have goals of full disclosure and transparency whenever a company sells stocks or bonds to the public. So when a private company, like Groupon, conducts a public offering, it must run a gauntlet of federal regulations and produce a detailed public disclosure document to give to investors and regulators.[2] Staff members at the Securities and Exchange Commission (SEC) review these disclosure documents, and in Groupon's case, they forced the company to amend its disclosures to increase their accuracy.[3]

[1] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

[2] *See* Securities Act of 1933 §§ 5, 10, 15 U.S.C. §§ 77e, 77j (2006). *See generally* 17 C.F.R. pt. 230 (2011).

[3] *See, e.g.*, Letter from Larry Spirgel, Assistant Dir., SEC, to Andrew D. Mason, Chief Exec. Officer, Groupon, Inc. 1–3 (June 29, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1490281/000000000011039811/filename1.pdf.

Private placements, on the other hand, take place when a company sells an investment outside of the normal public securities markets.[4] Private offerings largely escape both federal and state regulatory scrutiny.[5] In fact, because these offerings are private, they are often shrouded in dark secrecy. Issuers selling their securities privately generally disclose far less information to investors than is required during public offerings[6] and issuers disclose this information only to qualified investors.[7] Regulators and even academics have little or no access to the private placement disclosures. In addition, privately placed investments are not liquid, are difficult to price, and carry significant risks. Although not my topic tonight, most of the subprime securitized mortgages were sold privately, away from prying governmental and academic eyes.[8]

Over the past few years, thousands upon thousands of retail investors, like Grandma, have lost billions of dollars in risky private placements solicited by stockbrokers. Compared with sales in the public markets, brokers get a much higher commission when selling private placements, giving them an incentive to market them aggressively.[9] As one commentator recently noted: "For far too long, brokers have been selling their older clients complex investments . . . . They entered

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[4] Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2); 17 C.F.R. § 230.506 (2011).

[5] *See generally* Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151 (2010).

[6] Under the § 4(2) exemption, issuers must provide either access to or disclosure of the same kind of information contained in a registration statement. SEC v. Ralston Purina Co., 346 U.S. 119, 125–26 (1953). Conversely, SEC rule 506 does not require any particular disclosure. *See* 17 C.F.R. § 230.506. Private placement issuers, however, generally provide disclosures for anti-fraud purposes, although the quality of the disclosures varies widely.

[7] *See* 17 C.F.R. § 230.506. See also 17 C.F.R. § 230.501(a) (2011) for a definition of "accredited investor."

[8] Kenneth E. Scott & John B. Taylor, *Why Toxic Assets Are So Hard to Clean Up*, WALL ST. J., July 20, 2009, at A13.

[9] Liz Skinner & Bruce Kelly, *SEC Eyes Opening Up Private Placements*, INVESTMENTNEWS (May 15, 2011), http://www.investmentnews.com/article/20110515/REG/305159973. Some sources place the range of private placement commissions at 7–8%, *see, e.g.*, *Private Placements Face New Scrutiny By Regulators*, INVESTORPROTECTION.COM, (Apr. 11, 2011), http://www.investorprotection.com/blog/2011/04/11/private-placements-face-new-scrutiny-by-regulators/. FINRA, however, recently withdrew a proposal to cap commission at 15% in light of heavy resistance from the brokerage community, suggesting that higher commissions are common. Notice of Filing of Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities), Exchange Act Release No. 34-65585, 76 Fed. Reg. 65,758, 65,759–61 (Oct. 24, 2011). While commissions for trading public stocks vary widely, they are on the whole much lower, ranging from 1–2% at most for full commission brokers to flat fees for discount online brokers. *See, e.g.*, Elizabeth Ody, *The Best of the Online Brokers*, KIPLINGER'S PERSONAL FINANCE, Feb. 2011, at 34, *available at* http://www.kiplinger.com/magazine/archives/the-best-of-the-online-brokers-for-2011.html (reporting that discount brokers can charge as little as $2.50 per trade).

retirement portfolios like Trojan horses, and then destroyed people's life savings."[10]

Aggrieved investors in these cases have little recourse. Failed companies have little or no capacity to reimburse investors, forcing them to enter the uncertain and unprincipled world of securities arbitration against their brokers[11] or perhaps join a class action, where at best, they will receive only pennies per dollar of losses.[12]

Governmental regulation of private placements is minimal and has survived virtually unchanged for the past thirty years.[13] Suggested regulatory changes to protect retail investors are usually attacked as bad for business—especially for small business.[14] While Grandma may be the poster child for the innocent investor, a small business is the poster child for economic salvation. America loves small business—at least the ideal of small business—as the engine of entrepreneurial growth and job creation. Of course not all, indeed not even the majority, of small businesses perform as societal economic engines. Most provide employment only for their owners. Nevertheless, any regulation that purports in any way to impede capital formation by small business invariably comes under attack as "over regulation"—indeed un-American—as the diatribes from Washington, D.C. today make all too clear. [15]

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[10] JOHN F. WASIK, HOW SAFE ARE YOUR SAVINGS?: HOW COMPLEX DERIVATIVE PRODUCTS IMPERIL SENIORS' RETIREMENT SECURITY 1 (2011), *available at* http://www.theinvestigativefund.org/files/managed/How_Safe_Savings_Demos-Nation.pdf.

[11] *See generally* Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 459 (2008); Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 SEC. REG. L.J. 181 (2008); Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123 (2005).

[12] *See, e.g.*, Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 123 (1999).

[13] Rule 506 was enacted in 1982 and until 2010 had only been amended once. *See* 17 C.F.R. § 230.506 (1989); Adoption of Amendments to Accredited Investor and Filing Requirements, Securities Act Release No. 33-6825, 54 Fed. Reg. 11,369, 11,371 (Mar. 20, 1989) (amending Rule 506). Effective February 27, 2012 the SEC implemented new rules to conform to Section 413(a) of the Dodd–Frank Wall Street Reform and Consumer Protection Act. Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, 76 Fed. Reg. 81,793, 81,794, 81,805–06 (Dec. 29, 2011); *see also* Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010). Dodd–Frank mandated that the SEC amend its rules to exclude from the definition of "accredited investor" the value of an individual's primary residence and to disqualify defined "Bad Actors" from the Rule 506 safe harbor. *See* Dodd–Frank §§ 413, 926, 124 Stat. at 1577, 1851 (codified as a note to 15 U.S.C. §§ 77b, 77d).

[14] *See* Letter from Mary L. Schapiro, Chairman, SEC, to Rep. Darrell E. Issa, Chairman, Comm. on Oversight & Gov't Reform 1, 10–11, 16 (April 6, 2011), http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

[15] *See, e.g.*, Rep. Darrell Issa, *The Future of Capital Formation*, COMM. ON OVERSIGHT & GOV'T REFORM (May 10, 2011), http://oversight.house.gov/hearing/the-future-of-capital-formation ("Tuesday's hearing of the House Committee on Oversight and

As one commentator noted in an opinion piece in the Wall Street Journal:

> The reason why those who see economic regulations as akin to tyranny often win policy debates is because they have a fiery argument with visceral appeal. Those who try to sell the virtues of the supervisory state tend to favor the passive voice. They don't do fire. They do law review.[16]

And right now, Congress is seeing red hot fire and has enacted a flurry of proposals to expand the ability of companies to raise capital without having to comply with existing rules that critics contend are too onerous and too expensive.[17]

Of course missing from the current "let's cut regulation" rhetoric is the fact that most small businesses fail. Before the 2008 financial meltdown, statistics indicate that 50% of new business start-ups failed within five years of formation and nearly two-thirds failed within ten years.[18] In the last three years, this small business failure rate is up an additional forty percent.[19] One must be of stout heart, keen mind, and fat wallet to invest in these small business enterprises. To be sure, there can be a tradeoff between investor protection and legitimate capital formation activities, and reasonable people may differ on where to draw the line. The reality is, however, that these decisions today are more a product of political optics than rational thought. And, over time, Grandma has been on the losing end of the tug of war.

So tonight I would like to very briefly describe the private placement market; tell you a short, but sordid, little story about a company known as Medical Capital; discuss gatekeeper failures; and try to convince you that the system is broken and in need of repair. The repairs themselves are actually quite simple, if we have the political will.

The private placement market is actually several different markets. Traditionally, the top tier of this market consists of sellers that are public

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Government Reform will provide lawmakers with an opportunity to better understand how securities regulations have harmed public and private capital formation in the United States.").

[16] Thomas Frank, Op-Ed., *Obama and 'Regulatory Capture'*, WALL ST. J., June 24, 2009, at A13.

[17] *See, e.g.*, Access to Capital for Job Creators Act, H.R. 2940, 112th Cong. (2011) (removing the regulatory ban that prevents small, privately held companies from using advertisements to solicit investors). The bill was eventually incorporated into the 2012 JOBS Act. *See* Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012).

[18] *Frequently Asked Questions*, U.S. SMALL BUS. ADMIN. 1, http://www.sba.gov/sites/default/files/sbfaq.pdf (last updated Jan. 2011).

[19] *The State of Small Businesses Post Great Recession: An Analysis of Small Businesses Between 2007 and 2011*, DUN & BRADSTREET 2 (May 2011), http://www.dnbgov.com/pdf/DNB_SMB_Report_May2011.pdf.

companies or very large private companies such as Facebook.[20] The top tier placement agents (the brokers) are usually large investment banks such as Goldman Sachs. Investors in this market tend to be large institutions like TIAA-CREF. Traditionally, a huge percentage of this market consists of corporate bonds. For example, in 2010 top tier sellers privately placed $41 billion of corporate debt.[21]

The second tier of the private placement market is comprised of bundled equity investments sold only to very wealthy and sophisticated investors, such as hedge funds, private-equity funds and venture-capital pools. In 2010, there were over 3,000 reported venture capital deals totaling over $23 billion and private equity investments totaling $132 billion.[22]

In the third tier I place angel investors and angel groups. A working definition of "angel investor" is an investor who puts his or her own money into a company at an early stage of its development. Angels tend to be wealthy and sophisticated, and they personally perform due diligence—that is, they investigate a company before making an investment.[23]

There are interesting issues in all of these private placement markets, but tonight my concern is with a fourth tier of private placement activity—private placements sold to retail investors who are solicited by stockbrokers. Remarkably, for regulatory purposes, all of these private placements are treated relatively the same. That is, they are barely regulated. This one-size-fits-all model is a big part of the problem. A private placement to Grandma who is solicited by a stockbroker in a shopping mall is treated almost the same as a private placement sold by Morgan Stanley to Prudential Insurance Company.[24] In a 2010 article, I referred to private placements as a "regulatory black hole."[25]

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[20] On February 1, 2012 Facebook filed an S-1 Registration Statement with the SEC to launch an initial public offering, Facebook, Inc., Registration Statement (Form S-1) (Feb. 1, 2012), and the filing became effective May 18, 2012. Facebook, Inc., Prospectus (Form 424(b)(4)) (May 18, 2012).

[21] Radi Khasawneh, *Private Bond Market Takes Off*, FIN. NEWS (Apr. 4, 2011), http://www.efinancialnews.com/story/2011-04-04/private-bond-market-takes-off.

[22] *Recent Stats & Studies*, NAT'L VENTURE CAPITAL ASS'N, http://www.nvca.org/index.php?option=com_content&view=article&id=344&Itemid=103; *Private Equity Investment Turns the Corner in 2010*, PITCHBOOK (Jan. 5, 2011), http://www.pitchbook.com/pr_20110105.html.

[23] *See* Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 115–16, 118, 131 (2010). Other investors in private placements tend to be the family and close friends of the business owner. These investors are sometimes referred to as Friends, Family and Fools.

[24] Rule 144A allows issuers to privately sell securities to Qualified Institutional Buyers (QIB) so long as the same class of securities does not trade on the public markets. QIBs are defined as institutional investors with at least $100 million of securities not affiliated with the issuer. Rule 144A also allows QIBs to trade among themselves without restriction. 17 C.F.R. § 230.144A (2011).

[25] Johnson, *supra* note 5, at 155.

This introduction leads to my sordid little tale. I recently assisted the State of Massachusetts in a regulatory action seeking restitution against a broker–dealer known as Securities America.[26] It was here I learned firsthand how the sausage is made—so tonight, I am telling my story and naming names.

Securities America sold promissory notes as private placements in an enterprise known as Medical Capital (MedCap).[27] By most accounts, MedCap was a $2 billion Ponzi scheme.[28] MedCap was promoted and managed by two gentlemen: Mr. Sid Field and Mr. Joey Lampariello.[29] Sid Field was a shady character who in the early 1990's had owned and controlled automobile insurance companies in California. According to local news accounts, Sid was stripped of his insurance license and twice sued by California for racketeering and fraud.[30] Sid apparently engaged in a deceptive practice known as "sliming." He altered accident records and falsified information so bad drivers could qualify for insurance. Also, Sid reportedly "duped customers into paying interest rates of 21 percent to 40 percent when they financed their premiums."[31] Sid paid $100,000 to settle one of the state's claims before putting both himself and his insurance companies into bankruptcy.[32]

Well, you can't keep a good man down, and soon Sid teamed up with Joey Lampariello, another mysterious character from Huntington Station, New York.[33] Sid and Joey established MedCap to buy medical receivables at a discount from troubled doctors' offices and medical facilities.[34] Their ostensible plan was to make a profit by collecting the full face value of the receivables, largely from insurance companies.[35]

To finance the purchase of receivables, MedCap hired stockbrokers to sell promissory notes to retail investors, promising them interest rates ranging from 8.5–10.5%.[36] Investors were told their money was safe because it would be in the hands of "trustees" that were national banks

[26] Administrative Complaint at 1, Sec. Am., No. 2009-0085 (Mass. Sec'y of the Commonwealth, Sec. Div. Jan. 26, 2010), *available at* http://www.sec.state.ma.us/sct/sctsa/saidx.htm. Securities America is a wholly owned subsidiary of Ameriprise Financial, Inc. *Id.* at 2.

[27] Securities America sold approximately 37% of the MedCap notes, totaling $697 million. *Id.* at 2.

[28] Second Amended Complaint for Violations of the Federal Securities Laws at 7–24, SEC v. Med. Capital Holdings, Inc., No. SACV 09-818 DOC (RNBx) (C.D. Cal. Mar. 16, 2010) [hereinafter Second Amended Complaint].

[29] *Id.* at 5.

[30] Ronald Campbell, *Former Insurance Industry 'Bad Actor' Again Accused of Fraud*, ORANGE COUNTY REGISTER (Aug. 23, 2009), http://www.ocregister.com/news/field-191257-insurance-medical.html.

[31] *Id.*

[32] *Id.*

[33] *See* Second Amended Complaint, *supra* note 28, at 5.

[34] *Id.* at 7.

[35] *Id.* at 8.

[36] *Id.* at 8–9.

including Wells Fargo and Bank of New York (now BNY Mellon).[37] Investors were also told that their funds would be used to purchase only high quality receivables payable by insurance companies like Blue Cross & Medicare.[38]

One can readily see why these investments were attractive to seniors. The stockbrokers marketed the MedCap notes as guaranteed and safe investments. Moreover, traditional investing wisdom advises that as you grow older you should put the majority of your investments into fixed income instruments such as notes and bonds. As time went on, however, MedCap expanded beyond insurance receivables to other investments. For example, MedCap funded a cell phone application company whose sole product at the time was a live video feed of a hamster in a cage.[39] MedCap invested millions in a yacht, a movie, and, it appears, a porn web site.[40] All in all, MedCap, using the brokers, sold over $2 billion of notes to 20,000 investors as unregulated private placements.[41]

Those of you still awake might ask—how can $2 billion in sales to 20,000 retail investors be a transaction that regulators or anyone else would possibly deem private? To which I might answer: exactly![42]

Only the first MedCap entity ever made an operating profit and even so, it was not enough to pay principal and interest on the notes. In effect, MedCap was a Ponzi scheme. Given presidential hopeful Rick Perry's comments about social security, we probably had better define the term "Ponzi scheme": a Ponzi scheme is a fraudulent investment operation that pays returns to its investors either from the investors' own money or the money paid by subsequent investors, rather than from any actual profit earned by the enterprise.[43] So because MedCap did not make an operating profit—in typical Ponzi scheme fashion—in order to keep the

[37] Ronald Campbell, *Bribery Charge Hits Major MedCap Borrower*, OC WATCHDOG (Apr. 12, 2011, 1:42 PM), http://taxdollars.ocregister.com/2011/04/12/bribery-charge-hits-major-medcap-borrower/80255.

[38] *Id.*

[39] *See* Amended 10 Day Report and Accounting of Receiver Thomas A. Seaman, at 17, SEC v. Med. Capital Holdings, Inc., No. SA CV09-0818 DOC (RNBx) (C.D. Cal. August 14, 2009).

[40] *See* Ronald Campbell, *Receiver: 'Significant Losses' for MedCap Investors*, ORANGE COUNTY BUS. NEWS (Aug. 12, 2009, 2:57 PM), http://ocbiz.ocregister.com/2009/08/12/receiver-significant-losses-for-medcap-investors/; Nick Schou, *New Complications in the IHHI Saga*, OC WKLY. (July 30, 2009), http://www.ocweekly.com/2009-07-30/news/ihhi-sec-mch/.

[41] *See* Second Amended Complaint, *supra* note 28, at 7.

[42] SEC Rule 506 provides a safe harbor for sales to up to 35 sophisticated, non-accredited investors plus an *unlimited number* of accredited investors. 17 C.F.R. § 230.506 (2011). The Rule 506 exemption, however, is subject to the caveat that technical compliance will not excuse a "plan or scheme to evade the registration provisions of the Act." Preliminary Note 6, 17 C.F.R. §§ 230.501–.508.

[43] *See Avoiding Investment Scams*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P118010 (last updated Aug. 31, 2009).

company afloat, MedCap used money from new investors, like Grandma, to pay interest and principal to existing note holders.

In the meantime, Sid and Joey paid themselves massive fees in the hundreds of millions of dollars, including fees to transfer the receivables back and forth among the various MedCap entities.[44] At no time was there any independent valuation of the medical receivables (the only assets of the company) or any audited financial statements.

By the time the SEC sued MedCap for fraud in 2009 and the Court appointed a receiver, the company had more than a half-billion dollars in completely phony receivables on its books and had lost over $300 million on its actual investments.[45] And the so-called trustees, Wells Fargo and Bank of New York? In spite of the name "trustee," the banks had no contractual duties to do anything other than act as transfer agents that took directions solely from Sid and Joey. Indeed, investors claim that the banks signed off on requests by Sid and Joey to pay themselves multi-million dollar fees in violation of the note covenants.[46] MedCap losses added up to over $1 billion in principal—and so far the MedCap Receiver has collected less than fifteen percent of that amount.[47]

The sad fact is that on one level, this case is not remarkable. At $1 billion in losses, it doesn't come close to the multi-billion dollar Madoff Ponzi scheme.[48] And since Madoff, the SEC and state regulators have uncovered dozens more Ponzi schemes around the country.[49] What is remarkable is the number of people who potentially could have stopped MedCap but did not, including: the SEC; FINRA, the financial self-regulatory organization that regulates stockbrokers;[50] the brokers

[44] *See* Second Amended Complaint, *supra* note 28, at 11–12.

[45] Ronald Campbell, *Feds Launch Criminal Probe of Medical Capital*, ORANGE COUNTY BUS. NEWS (Mar. 22, 2010, 3:27 PM), http://ocbiz.ocregister.com/2010/03/22/feds-launch-criminal-probe-of-medical-capital/17513/.

[46] *See* Complaint at 2–3, Masonek v. Wells Fargo Bank, No. SACV09-1048 AG (RNBx) (C.D. Cal. Sep. 11, 2009); *see also* Bruce Kelly, *Wells Fargo, BNY Mellon Sue Securities America, Other B-Ds Over MedCap*, INVESTMENTNEWS (May 26, 2011), http://www.investmentnews.com/article/20110526/FREE/110529948.

[47] *See* Receiver's Thirty-Fourth Report to the Court at 5, SEC v. Med. Capital Holdings, Inc., No. SA CV09-0818 DOC (RNBx) (C.D. Cal. May 10, 2012); *see also* Second Amended Complaint, *supra* note 28, at 2.

[48] *See* Aaron Smith, *Madoff Ponzi Prosecutors: Still Trying to Tally Loss*, CNNMONEY (Sep. 28, 2009, 7:16 AM), http://money.cnn.com/2009/09/24/news/economy/madoff_ponzi/index.htm.

[49] Thomas O. Gorman, *A Ponzi Scheme Case With a Better Ending*, LEXISNEXIS CORP. & SEC. L. COMMUNITY (Apr. 20, 2011, 7:07 PM), http://www.lexisnexis.com/community/corpsec/blogs/corporateandsecuritieslawblog/archive/2011/04/20/a-ponzi-scheme-case-with-a-better-ending.aspx.

[50] The Financial Industry Regulatory Authority (FINRA) was formed in 2007 by a consolidation of the enforcement arms of the New York Stock Exchange, NYSE Regulation, Inc., and the National Association of Securities Dealers (NASD). Order Approving Proposed Rule Change to Amend the By-Laws of NASD, Exchange Act Release No. 34-56145, 91 SEC Docket 404 (July 26, 2007).

themselves; the banks; the attorneys; and the independent due diligence analysts.

I would like to highlight a few of these gate-keeping failures, beginning with the SEC. I earlier explained that the private placement market operates in a regulatory vacuum and that private placements are exempt from the public offering rules. As interpreted by the United States Supreme Court, the statutory private placement exemption allows companies to avoid the public offering rules if they sell only to those who are financially sophisticated and have access to the same kind of information that they would receive in a registered public offering.[51] An investor like Warren Buffet would qualify under this test. Companies and their lawyers, however, found it difficult to know for sure if a potential investor was in fact financially sophisticated under the Supreme Court test and which kind of disclosure was necessary. So, in 1982, the SEC developed the concept of an "accredited investor."[52] The SEC defined accredited investor to include institutions such as insurance companies and large pension funds,[53] and people, like Grandma, who have $1 million in assets or an annual income of at least $200,000.[54] By rule, the SEC provides that sales to accredited investors qualify as private placements with no regulatory oversight.[55] Under current SEC regulations, wealth (at least measured by 1982 standards) is a complete substitute for financial sophistication and required disclosure. Consequently, today most issuers limit their private placement offerings only to accredited investors.[56]

The Dodd–Frank Act, enacted by Congress in the summer of 2010, produced the first real changes to these private placement rules in thirty years.[57] First, the Act disqualified defined "Bad Actors" from using the private placement exemption.[58] But, as it turns out, this "Bad Actor"

[51] SEC v. Ralston Purina Co., 346 U.S. 119, 125–27 (1953).

[52] Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251, 11,252–54 (Mar. 16, 1982); *see also* 17 C.F.R. 230.501(a) (2011).

[53] 17 C.F.R. § 230.501(a)(1).

[54] *Id.* § 230.501(a)(5)–(6) (or $300,000 annual joint income with one's spouse).

[55] *Id.* § 230.506(b)(2)(ii); *see also* Johnson, *supra* note 5, at 179–88 (discussing how the National Securities Markets Improvements Act of 1996 (NSMIA) preempts state law regarding private placements in favor of no regulation).

[56] A recent study of Regulation D offerings under Rule 505 or 506 from 2009–2010, found that the average number of non-accredited investors numbered 0.1 and that in 90% of the offerings there were no non-accredited investors. Vlad Ivanov & Scott Bauguess, *Capital Raising in the U.S.: the Significance of Unregistered Offerings Using the Regulation D*, SEC. & EXCHANGE COMMISSION, 6 (Feb. 2012), http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf.

[57] Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[58] *Id.* § 926, 124 Stat. at 1851.

provision would not have disqualified Sid & Joey.[59] Second, the Dodd–Frank Act provides that the value of a retail investor's home must be excluded when calculating wealth under the accredited investor test.[60] Finally, the Act directs the SEC to review the appropriateness of the $1 million wealth standard itself and to consider whether to change it.[61] However, the Act prohibits any modifications to the standard until July, 2014.[62] The 2010 Dodd–Frank "do not count the house" rule may have impacted the MedCap offering. Many victims in MedCap were retired or hope-to-be-retired retail investors who were solicited by their stockbrokers.[63] The brokers helped the investors add up the supposed value of their homes, furniture, cars, trucks, dogs and kids to get to the $1 million asset value to qualify them as accredited. One might hope that removing the house from the $1 million calculation will help protect Grandmas. On the other hand, one cannot underestimate the ingenuity of a motivated commissioned sales force. Far too many of these brokers behave like sea lions camped at the foot of Bonneville Dam gobbling up helpless salmon. For example, I have recently learned that some brokers are routinely using the present value of Grandma's social security and pension payments to get to the $1 million mark to qualify an investor as accredited. Moreover, this accredited investor safe harbor rule works more or less on the honor system. While private placement sellers must

[59] Proposed Rule 506(c), implementing Dodd–Frank § 926, disqualifies defined "bad actors" from utilizing Rule 506. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Dodd–Frank Act Release No. 33-9211, 76 Fed. Reg. 31,518 (proposed June 1, 2011) (to be codified at 17 C.F.R. pts. 230, 239). Sid may have qualified as a "Bad Actor" under this provision due to his earlier problems with California Insurance Regulators. However, the Proposed Rule only contemplates a ten-year look back, putting Sid beyond its reach by the time of the MedCap sales. *Id.* at 31,520.

[60] Dodd–Frank § 413(a), 124 Stat. at 1577. The SEC's implementing Rule became effective February 27, 2012. *See* 17 C.F.R. § 230.501(a); Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, 76 Fed. Reg. 81,793, 81,794 (Dec. 29, 2011).

[61] Dodd–Frank § 413(b), 124 Stat. at 1577–78.

[62] *Id.* § 413(b)(2). An earlier draft of the Dodd–Frank legislation directed the SEC to immediately adjust the accredited investor standard to adjust for inflation. *See* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 412 (with inflation, the $1 million threshold set in 1982 is the equivalent of $2.34 million today). However, the business lobby defeated this change as it had defeated earlier SEC efforts to increase the wealth threshold. *See, e.g.*, Letter from The Fin. Servs. Roundtable et al., to the Members of the U.S. Senate (May 14, 2010), *available at* http://www.reit.com/PolicyPolitics/CreditMarketChallengesChanges/~/media/Portals/0/PDF/IndustryLetterSupportingBondAmndt051410.ashx (opposing the increase in the accredited investor wealth thresholds).

[63] *See, e.g.*, Campbell, *supra* note 30; Susanne Craig, *Financial Fraud Case Pits Arbitration vs. Class Actions*, N.Y. TIMES DEALBOOK (Mar. 4, 2011, 7:50 PM), http://dealbook.nytimes.com/2011/03/04/financial-fraud-case-pits-arbitration-vs-class-actions/ [hereinafter Craig, *Arbitration vs. Class Actions*].

file a form D with the SEC, the required information is minimal, and the SEC staff rarely reviews or even looks at these forms in any event.[64]

On its website, the SEC makes a puzzling suggestion: it suggests that if investors have questions about private placement companies, they should contact their state regulators.[65] On the surface this is not a bad idea, as state regulators, in fact, are generally pretty good at investor protection—especially for seniors. Unlike the SEC, state regulators used to actually review private placement filings. What makes the SEC's suggestion puzzling is that in 1996, Congress, in its infinite wisdom, preempted—that is prohibited—states from regulating these private placement offerings at all.[66] I suggested in an earlier article that Congress undo federal preemption for small business private placements and let state regulators once again have a crack at these retail deals before they are marketed.[67] These ideas were actually presented to Congress as well as to the Financial Crisis Inquiry Commission, but they fell on deaf ears.[68] I apparently was *only* "doing law review."

To summarize, the SEC rules allow companies to sell any dollar amount of private placement investments to an unlimited number of defined accredited investors with virtually no governmental oversight. Like in the Land of Oz, with private placements, when you peel back the white curtain: there is no wizard.

As I mentioned earlier, the SEC private placement rules do not mandate disclosure to accredited investors. In practice, however, sellers will usually prepare a disclosure document both as a selling vehicle and to provide protection against potential investor fraud suits. MedCap, indeed, used at least six disclosure documents,[69] each drafted by the law firm of Manatt Phelps, a firm with more than 400 lawyers with offices in

[64] *See* 17 C.F.R. § 230.503(a) (2011); *see also* Johnson, *supra* note 5, at 170 n.116.

[65] *See Regulation D Offerings*, SEC, http://www.sec.gov/answers/regd.htm (last modified Dec. 12, 2009).

[66] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, sec. 102(a), § 18(a)–(b), 110 Stat. 3416, 3417–19 (codified at 15 U.S.C. § 77r(a)–(b)).

[67] Johnson, *supra* note 5, at 198. The original discussion draft of the senate Bill that eventually became the Dodd–Frank legislation would have returned authority to state regulators to review private placements before sale. *See* Restoring American Financial Stability Act of 2009, S. Discussion Draft, 111th Cong. § 1042 (2009), *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[68] *See, e.g.*, *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 7 (2009) (Testimony of Fred J. Joseph, President, North American Securities Administrators Association) (arguing for restored state authority over Rule 506 offerings); *see also First Public Hearing of the Financial Crisis Inquiry Commission* 4–6 (Jan. 14, 2010) (Testimony of Denise Voigt Crawford, Comm'r, Texas Securities Board, and President, North American Securities Administrators Association, Inc.), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0114-Transcript.pdf (quoting Johnson, *supra* note 5, at 155).

[69] *See* Administrative Complaint, *supra* note 26, at exhibits C, D, I, N, O, and S.

California, New York and Washington, D.C.[70] In short, the MedCap disclosures are incomprehensible. I have read each of them many times, and I could not even tell you the MedCap business model—that is, how they really hoped to make money—nor could the Massachusetts lawyers who had spent months and months on nothing else. Last Spring, I assigned to my Advanced Seminar students the task of carefully reading one of the MedCap disclosures and explaining it to the class. These students are truly the smartest people in the room. Of the ten law students, I received ten very different and very confused answers. Imagine Grandma trying to make sense of these documents.

The red warning flags actually buried in the MedCap disclosures are astounding.[71] The documents scream *Ponzi scheme!* if one could navigate and understand the conflicting and confusing language. This leads to an interesting question: is it fraud if I tell you ahead of time that I plan to steal from you? We might ask: should the Manatt Phelps attorneys who drafted these disclosures have asked more questions? Or at least some questions over the eight years they represented MedCap? Do the attorneys have potential liability? In a word: No, unless they are Oregon attorneys (but that is a different topic).[72]

So how did MedCap market $2 billion of promissory notes to 20,000 unsuspecting investors? The notes were marketed by dozens of stockbrokers who would call up Grandma and peddle the notes as "safe investments" due to their fixed interest rates and "guaranteed returns." Sometimes Grandma and her friends would get an invitation for a free dinner, where the MedCap documents would be piled on a table along with advertising literature stating that the notes should be included in the investors' "Fixed Income Arsenal."[73] The motivations for brokers to sell private placements lie in the relatively large commissions they receive. While commissions for trading public stocks are very low—usually less than 2%—commissions for private placements and other so-called alternative products can be very high—sometimes exceeding 15%—giving brokers an extra incentive to push the products.

Brokers selling MedCap notes included Securities America, an independent broker–dealer located in Omaha, Nebraska that sold $700 million of the notes.[74] A recent news article dubbed Securities America the "[b]oiler room on [the] prairie."[75] Lest you think that Securities

[70] *Fact Sheet*, MANATT, PHELPS & PHILLIPS, LLP, http://www.manatt.com/generic.aspx?id=45; *Offices*, MANATT, PHELPS & PHILLIPS, LLP, http://www.manatt.com/Offices.aspx.

[71] *See generally* Administrative Complaint, *supra* note 26, at exhibit D.

[72] *See* Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463 (2011) (detailing secondary liability for securities fraud under state blue sky laws).

[73] *Id.*

[74] *See* Kelly, *supra* note 46; *see also* Mike Hughlett, *Ameriprise to Sell Its Securities America Unit*, STAR TRIB., Aug. 18, 2011, at D1.

[75] Eric Wieffering, *Securities America: Boiler Room on Prairie*, STAR TRIB., Apr. 28, 2011, at D1.

America is just a small bucket shop, it was then a wholly owned subsidiary of Ameriprise, a Fortune 300 company.[76] In August of 2011, Ameriprise sold Securities America, deciding that it was no longer in keeping with Ameriprise's current "you can trust us" advertising campaign.[77] The list of the other broker–dealers that are now out of business due to MedCap and other private placement sales is impressive.[78] Unable to finance their legal battles, many broker–dealers have simply shut their doors, leaving investors and their losses out in the cold.[79]

Stockbrokers are regulated by FINRA, the Financial Industry Regulatory Authority, under rules loosely supervised by the SEC.[80] FINRA is a Self Regulatory Organization (SRO) that is entirely funded by fees from the brokers it regulates. For some, the term "regulatory capture" may come to mind.[81] Under FINRA rules, brokers do have obligations in soliciting investors to buy these private placement deals. First, the brokers must ensure that they are only offering and selling to accredited or sophisticated investors.[82] Next, FINRA rules require brokers to conduct substantive due diligence. Brokers must investigate a company and its managers before selling the private placement securities.[83]

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[76] *Client FAQs About Money Market Fund Developments*, SEC. AM. 1 (rev. Mar. 4, 2009), http://www.securitiesamerica.com/downloads/ClientMoneyMktFAQs030409.pdf.

[77] Hughlett, *supra* note 74.

[78] *Broker–Dealers That Sold MedCap Notes*, INVESTMENTNEWS (May 26, 2011), http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20110526/CHART/110529952.

[79] *See, e.g.*, Bruce Kelly, *Finra Orders Belly-Up B–D to Pay Whopper of an Award*, INVESTMENTNEWS (Jan. 19, 2012), http://www.investmentnews.com/article/20120119/FREE/120119910 (FINRA panel awarded private placement investor $9 million against Broker–Dealer that is no longer in business and has no assets).

[80] *See* Ben Protess, *Finra Executives Get Big Payday*, N.Y. TIMES DEALBOOK (July 1, 2011, 10:54 AM), http://dealbook.nytimes.com/2011/07/01/finra-executives-get-big-payday/; *see also* Roberta S. Karmel, *Is the Financial Industry Regulatory Authority a Government Agency?* 2, 7, 10 (Brooklyn Law Sch. Legal Studies Research Papers, Research Paper No. 86, 2007), *available at* http://ssrn.com/abstract=1018396.

[81] *See* Steven M. Davidoff, *The Government's Elite and Regulatory Capture*, N.Y. TIMES DEALBOOK (June 11, 2010, 2:00 PM), http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture/; *see also* Letter from Danielle Brian, Exec. Dir., Project on Gov't Oversight, to Chairman and Ranking Member, House and Senate Comms. (Feb. 23, 2010), *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html. FINRA executives enjoy 7-figure salaries. Protess, *supra* note 80.

[82] SEC Rule 506 exempts only sales to defined accredited investors and up to 35 non-accredited but sophisticated investors from the registration requirements of the 1933 Securities Act. 17 C.F.R. § 230.506 (2011).

[83] *See* FINRA Rule IM-2310-2, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3640; *see also* FINRA, REGULATORY NOTICE 10-22, REGULATION D OFFERINGS: OBLIGATION OF BROKER–DEALERS TO CONDUCT REASONABLE INVESTIGATIONS IN REGULATION D OFFERINGS 4–7 (Apr. 2010), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf (obligations of Broker–Dealers to conduct reasonable investigations in Regulation D offerings); NASD, NOTICE TO MEMBERS 05-18, PRIVATE PLACEMENTS

It is clear that many individual broker representatives do not themselves have the financial sophistication or training to understand the products they sell. Indeed, in the case of Securities America, some of the brokers believed their own sales pitches and invested personal funds in MedCap. Instead, individual brokers must generally rely on the due diligence efforts of their home offices. The due diligence committee for Securities America was housed in its home office in Omaha, Nebraska.[84] In investigating MedCap, the in-house committee relied upon information it obtained from Sid and Joey.[85] In addition, the committee hired an outside due diligence expert to study MedCap before allowing its brokers to sell the notes.[86] Securities America's due diligence expert was Mr. Bryan Mick, an attorney, also from Omaha.[87] Mr. Mick, it turns out, is the utility infielder of due diligence experts—he provided this due diligence service for almost all of the broker–dealers who sold MedCap notes and for many, many other private placement products as well.[88] According to industry practice, MedCap—the issuer (i.e. Sid and Joey)—paid Mr. Mick to investigate the company.[89] Here we have one local attorney opining on the suitability of $2 billion of notes, while being paid by the seller of those notes. So what kind of job did Mick do?

The answer: marginal. He actually picked up some red flags, but buried them among routine risk disclosures. More problematically, he relied too heavily on assurances from Sid and Joey without enough independent analysis. For example, nothing in Mick's many reports suggest that Sid, the CEO of MedCap, had been run out of California amidst fraud and racketeering charges when a simple Google search would have disclosed this information in five minutes.[90]

OF TENANTS-IN-COMMON INTERESTS 1, 4–5 (2005), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013455.pdf; NASD, NOTICE TO MEMBERS 03-71, NON-CONVENTIONAL INVESTMENTS 765, 767–68 (2003), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003070.pdf. The NASD regulations will be superseded by FINRA Rule 2111. FINRA Manual Rule 2111 (effective July 9, 2012), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

[84] Administrative Complaint, *supra* note 26, at 6; *About Us: The Company*, SEC. AM., http://www.securitiesamerica.com/igsbase/igstemplate.cfm?SRC=DB&SRCN=&GnavID=6&SnavID=40.

[85] *See* Administrative Complaint, *supra* note 26, at 26; Second Amended Complaint, *supra* note 28, at 2.

[86] Administrative Complaint, *supra* note 26, at 7–12.

[87] *Our People*, MICK & ASSOCIATES, P.C., LLO, http://mickandassociates.com/people-bryan-mick.html.

[88] Bruce Kelly, *Lawyer to Finra: Private-Placement Litigants Suffering From 'Selective Amnesia'*, INVESTMENTNEWS (Feb. 10, 2010), http://www.investmentnews.com/article/20100210/FREE/100219984/.

[89] Administrative Complaint, *supra* note 26, at 25–26.

[90] In a 2010 letter sent to FINRA's executive director of enforcement, Bryan Mick, while applauding FINRA's recent efforts to "lower the boom on shady private placements," reminded FINRA that private placement investors often have "selective amnesia." Kelly, *supra* note 88.

FINRA rules also require brokers selling private placements to check to see if these notes—even if okay on their own—are suitable for a particular investor.[91] In making this analysis, brokers must consider the investor's age, other investments, financial situation and investment objectives, among other criteria.[92] And you can guess the brokers' conclusion: the MedCap notes always seemed suitable for Grandma. MedCap investors included an 88 year old who lost her life savings;[93] an 85-year-old retired grocery wholesaler who had dementia; and a 77-year-old with Alzheimer's disease, whose children had requested the broker not to contact him.[94]

In the aftermath of MedCap, the SEC brought civil actions against MedCap, Sid and Joey,[95] and just last week, federal prosecutors charged Joey with misdemeanor counts of tax evasion.[96] For now, Sid does not face criminal liability. In addition, the MedCap investors sued their brokers, and everyone else in sight including the "trustees" (Wells Fargo and Bank of New York).[97] The trustees, in turn, sued all of the selling brokers—apparently even those that have closed up shop.[98] Investors also filed numerous FINRA arbitrations claims against their brokers, and

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[91] Doug Cornelius, *FINRA Guidance on Private Placements*, COMPLIANCE BUILDING (April 28, 2010), http://compliancebuilding.com/2010/04/28/finra-guidance-on-private-placements/.

[92] FINRA Manual Rule 2310, (effective July 9, 2011), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638. Effective July 9, 2012, NASD Rule 2310 will be incorporated into FINRA Rule 2111. FINRA Manual Rule 2111, *supra* note 83.

[93] Bruce Kelly, *MedCap-Selling Broker Charged with Fraud*, INVESTMENTNEWS (Feb. 27, 2012), http://www.investmentnews.com/article/20120227/FREE/120229936#.

[94] *See, e.g.*, Ronald Campbell, *MedCap Brokers Scored Big Commissions, Parties*, OC WATCHDOG (June 3, 2011, 10:00 AM), http://taxdollars.ocregister.com/2011/06/03/medcap-brokers-scored-big-commissions-parties/84399/; Craig, *Arbitration vs. Class Actions*, *supra* note 62; Susanne Craig, *Judge Backs Arbitration in Case Against Securities America*, N.Y. TIMES DEALBOOK (Mar. 18, 2011, 7:25 PM), http://dealbook.nytimes.com/2011/03/18/judge-backs-arbitration-in-securities-america-case/.

[95] Second Amended Complaint, *supra* note 28, at 1.

[96] Bruce Kelly, *MedCap Exec Lampariello Faces Tax Evasion Charges*, INVESTMENTNEWS (Oct. 23, 2011), http://www.investmentnews.com/article/20111023/REG/310239954. In April, 2012 federal prosecutors also filed a single felony charge of wire fraud against Lampariello. *See* Ronald Campbell, *Feds Charge MedCap Boss with Wire Fraud*, OC WATCHDOG (April 16, 2012, 2:23 PM), http://taxdollars.ocregister.com/2012/04/16/feds-charge-medcap-boss-with-wire-fraud/153159/. On May 7, 2012 Lampariello pled guilty to both charges and now awaits sentencing. *See* Ronald Campbell, *President of 'Ponzi-like' Fraud MedCap Pleads Guilty,* OC REGISTER (May 7, 2012, 9:59 PM), http://www.ocregister.com/articles/medcap-353057-lampariello-million.html. In addition, Colorado prosecutors recently charged a local broker with criminal fraud in connection with sales of the MedCap notes. Kelly, *supra* note 94.

[97] Complaint, *supra* note 46, at 1.

[98] Kelly, *supra* note 46.

FINRA has launched investigations.[99] The majority of the class action and FINRA arbitration claims against Securities America settled. It looks like at the end of the day, the MedCap investors solicited by Securities America brokers may get back 40–50% of their principal (minus attorney's fees), which is really good as these things go, and largely possible due to large contributions by Ameriprise to the Securities America settlement fund.[100] Other MedCap investors, however, may not be so lucky and can expect to collect only pennies on the dollar.

So how could a $2 billion Ponzi scheme involving 20,000 investors fly under the radar for six years with so many potential gatekeepers involved? No one—not the MedCap attorneys, the stockbrokers, the home office of the brokers, the due diligence analyst, the banks, FINRA or the SEC which has oversight over the entire process—appeared to have a clue what was going on.

There is no question that these $2 billion in sales to retail investors would not have been possible except for the selling efforts of countless stockbrokers. Ironically, the SEC channels these private placement sales into the broker–dealer network hoping against hope that the FINRA rules governing broker–dealer conduct will protect investors like Grandma.[101]

I don't mean to suggest that most private placements are fraudulent, because they are not. The vast majority represent fundraising efforts by legitimate business entities—albeit extremely risky ones. And I do not mean to suggest that all stockbrokers engage in this behavior. They do not. In fact, the larger wire houses seldom touch this stuff. But, there are thousands of independent brokers in the United States that do. I am telling you the sordid tale of MedCap to explore the shadowy and unregulated arena of private placements that continues unabated within today's volatile public markets. Given the low yields on traditional, safe, fixed-income investments like treasuries or bank CDs, private placements are growing exponentially. Stockbrokers are convincing their clients to bail out of traditional diversified investments to buy alternative products. While Grandma represents all retail investors, I should note that over-65 seniors are particularly vulnerable to these sales tactics. Brokers target

[99] Ultimately FINRA levied a $250,000 fine against Securities America for its role with the sale of Provident Royalties LLC Private Placements but has not disciplined the firm at all for its role in MedCap. Bruce Kelly, *Finra Goes Public with Private-Placement Crackdown*, INVESTMENTNEWS (Nov. 29, 2011), http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20111129/FREE/111129895.

[100] Bruce Kelly, *Half a Loaf? Securities America Puts Offer on the Table*, INVESTMENTNEWS (Mar. 29, 2011), http://investmentnews.com/article/20110329/FREE/110329926. Securities America settled the class-action suit in the summer of 2011 as well as separate arbitration claims. Billitteri v. Sec. Am., Inc., No. 3:11–cv–00191–F, 2011 WL 3586217, at *2–3, *16 (N.D. Tex. Aug. 4, 2011).

[101] *See* News Release, FINRA, FINRA Sets Regulatory Guidance for Investigating Private Placements (Apr. 20, 2010), *available at* http://www.finra.org/Newsroom/NewsReleases/2010/P121305.

retirement communities to peddle these high commission products. There are tales of brokers convincing clients to transfer money from established pension plans to invest in alternative deals.

Our current private placement regulations are not only ineffective—they are also disingenuous. That's why I refer to them as a "regulatory Ponzi scheme"—they promise protections they do not deliver. Moving forward—fixing this problem does not necessarily mean more regulation; it means different, more effective regulation.

So how have the federal regulators responded so far to MedCap and the many other private placement Ponzi schemes? They are tending to nip around the edges hoping that small adjustments and warnings will prove satisfactory. For example, last year FINRA proposed a rule to cap private placement broker commissions at a hefty fifteen percent, but FINRA recently withdrew the proposal after encountering strong opposition from the brokers.[102] FINRA continues to warn brokers that they should do more due diligence on private placements and make sure that they are suitable for customers,[103] but FINRA has disciplined very few of these brokers for any violations.[104] In October of 2011, FINRA proposed a new rule that, if adopted, will require broker–dealers to file private placement disclosure documents with FINRA within fifteen days after their first sale.[105] It is not yet clear what FINRA will do with these filings, but *hopefully* qualified staff will actually read them and *maybe* stop more questionable offerings before they go on too long.

Meanwhile, over at the SEC, how is the Commission responding to this spate of private placement Ponzi schemes? In September of 2011, the Commission established a small business advisory committee to air the concerns of small business.[106] To be fair, in 2009 the SEC established a retail investor advisory committee.[107] I testified at its first meeting in May

[102] Notice of Filing of Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities), Exchange Act Release No. 34-65585, 76 Fed. Reg. 65,758, 65,759–61 (Oct. 24, 2011).

[103] *See id.* at 65,761; FINRA, REGULATORY NOTICE 12-03, COMPLEX PRODUCTS (Jan. 2012), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf.

[104] News Release, FINRA, FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation (Nov. 29, 2011), *available at* http://www.finra.org/Newsroom/NewsReleases/2011/P125193.

[105] Notice of Filing of Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities), 76 Fed. Reg. at 65,759. In light of industry opposition, FINRA narrowed its rule proposal and on June 7, 2012 the SEC adopted the rule as amended. Exchange Act Release No. 34-67157, 77 Fed. Reg. 35,457 (June 13, 2012).

[106] Press Release, SEC, SEC Announces Formation of Advisory Committee on Small and Emerging Companies (Sept. 13, 2011), *available at* http://www.sec.gov/news/press/2011/2011-182.htm.

[107] *Id.*

of 2010. While not in any way linked to my testimony,[108] the SEC suspended the committee two months later and it has not met again.

Last spring, SEC Chair Mary Schapiro outlined to Congress significant reforms to private offering regulations then under consideration by her staff.[109] These SEC reforms included relaxing the current ban on private placement advertising.[110] At present, the SEC prohibits the advertising of private placements, which it defines as any general solicitation, including giving private placement disclosures to anyone who does not qualify as an accredited investor.[111] The idea is that the advertising ban helps prevent securities fraud by making it more difficult for fraudsters to attract investors.

However, Congress has now directed the SEC to remove the advertising ban in light of critics who argue that the ban harms small business by making it more difficult to identify qualified investors. The 2012 JOBS Act directs the SEC to amend Rule 506 to remove the restrictions on general solicitations.[112] On one hand, this is quite incredible—in light of ever-mounting evidence of private placement fraud and misuse—that the SEC and Congress are loosening the regulatory restrictions. In a strange and twisted way, however, relaxing the advertising ban is probably a good first step, but for reasons not yet apparent to the Commission or to members of Congress.

The SEC advertising ban channels much fundraising into the sea lions we know as stockbrokers. The SEC implicitly assumes that interspersing brokers between companies and investors will result in investor protection, an assumption clearly belied by recent history. Relaxing the advertising ban may enable companies to find more sophisticated angel investors to provide funds without the necessity of employing a broker.

However, I believe the combination of advertising plus continued and unfettered broker–dealer activity, would be a disaster. So here is one very simple suggestion: to keep control over the brokers, we need to couple the advertising initiative with an upper limit on the number of individual investors in a private placement. I find it remarkable that in none of the dozens of lawsuits involving MedCap is anyone alleging that an offering to 20,000 retail investors cannot be a private placement due to the sheer number of investors. If these were equity investments—that is, if Grandma was purchasing stock—there would be a limit of 500

[108] My testimony to the committee concerned securities arbitration. *See* Press Release, SEC, SEC Investor Advisory Committee Announces Meeting Agenda, List of Participants (May 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-77.htm.

[109] *See* Letter from Mary L. Schapiro, *supra* note 14, at 1–5.

[110] *Id.* at 4.

[111] 17 C.F.R. § 230.502(c) (2011).

[112] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, § 201(a), 126 Stat. 306, 313–14 (2012) (codified as a note to 15 U.S.C. § 77d). SEC rules are forthcoming.

investors.[113] If a company exceeds the limit, it becomes a public reporting company. But there is no upper limit of investors on sales of promissory notes or other debt instruments, and there probably should be. With a limited number of investors, the brokers would not be tempted with massive commissions: the cost, the hassle, and potential liability inherent in the due diligence process would not be worthwhile.[114] This fix is so easy that even the SEC could do it.[115]

Next, if we are going to use wealth as a surrogate for sophistication, the 1982 accredited investor wealth threshold of $1 million for individuals must change no matter how much pushback there is from the business lobby. Now, as a policy matter, we can and should have the following debate: even if the wealthy need protection, do the wealthy deserve it? In response, let me summarize with the observation that it is not the wealthy we must protect: it is their money; their investment funds. We need these funds channeled into legitimate business enterprises to support the economy and help the rest of us. As the recent financial crisis so vividly demonstrates, we are all harmed when investment monies are siphoned off for nefarious ventures, be they sketchy private placements or sketchy mortgage securitizations that leave formerly wealthy investors and institutions unable to care even for themselves. But before engaging in the policy debate, first let's make sure Grandma is in fact wealthy—and not by valuing her future social security and pension payments.

Finally, we must reexamine the concept of the sophisticated investor—the angel investor. Our "one-size-fits-all" theory of private placement regulation does them, and small business, a disservice. As it now stands, however, the SEC, by channeling capital formation into the broker network is implicitly supporting a multi-billion dollar problem that is not going away.[116] To the contrary, it is getting worse. For anyone

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[113] Formerly, Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g)(1)(B) (2006), required companies with more than $1 million and assets and over 500 shareholders of record to file public reports. Title V of the JOBS Act immediately increased the 500 shareholder threshold to 2000 shareholders so long as no more than 500 are unaccredited investors. Employees of the issuer are also excluded from the shareholder count. JOBS Act §§ 501–02, 126 Stat. at 325–26.

[114] *E*.g., Great Britain and the European Union will set the investor number for similar regulations at 150. Financial Services and Markets Act, 2000, c. 8, § 86 (U.K.); Council Directive 2010/71, art. 1 § 3, 2010 O.J. (L 327) 1, 6.

[115] A recent study of Regulation D offerings suggests while this reform may impact a few hundred private placements each year , it would not impact the vast majority of Regulations D offerings. Ivanov & Bauguess, *supra* note 56, at 6 (Reporting that from 2009 to 2010, 90% of the early 50,000 Reg. D offerings involved approximately 30 investors and 99% of the offerings involved fewer than 155 investors).

[116] Unfortunately, Congress recently made the problem worse. Title III of the JOBS Act amends the 1933 Act to create a new crowdfunding exemption permitting private securities sales to an unlimited number of retail investors. JOBS Act §§ 301–303, 126 Stat. at 315–21. Under the crowdfunding exemption, issuers can raise up to $1 million

of you old enough to remember the musical "The Music Man" what we have here is *Trouble*—with a capital T that rhymes with B, that stands for—well, you can fill it in. While FINRA rattles its sabers, only a statute or Commission rule restricting the marketing of private placements to retail investors like Grandma will stem this tide of trouble.

At present, however, it is the business lobby that has the ear of Congress and the SEC—and it presents only the message of anti-regulation. Eventually, Congress will schedule additional hearings, and I hope to be there to fight fire with fire and not just do law review. In this tug of war, I hope to add some weight to the rope—and I will be pulling for Grandma.

annually within parameters related to the investors net worth. This exemption is expressly conditioned upon the issuer utilizing brokers or other "funding portals" registered with the SEC. The new exemption permits limited advertising, practically guaranteeing additional broker solicitations to retail investors. While this new crowdfunding exemption contains requirements for selling brokers that mirror FINRA rules and is subject to future SEC rulemaking, there is a very real probability that unsophisticated retail investors will experience significant broker selling pressures and suffer unexpected losses in securities they buy under this exemption. Moreover, the JOBS Act preempts state regulation of crowdfunding sales. *See id.*