Commentary: The Winds of Change Blow on Private Offerings

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On April 26, 2010, Phillip Offill, Jr., was sentenced to eight years in prison for participating in a series of pump-and-dump stock frauds. Along with the sentence, U.S. District Judge Liam O'Grady delivered a strong tongue-lashing to Mr. Offill: "Your testimony . . . was an affront to justice. It was one of the biggest pack of lies I've ever heard."

The Offill case strikes a chord with members of the securities bar, for he was one of our own, gone bad. Mr. Offill spent 15 years as an enforcement attorney for the Securities and Exchange Commission before leaving to accept a partnership with Godwin Gruber in Dallas.

The pump-and-dump scheme orchestrated by Offill, and another securities lawyer, David Stocker, was fairly typical of this type of fraud. They created some corporations, in most jurisdictions accomplished by filing simple certificates of incorporation and a filing fee that runs about $100 payable with a credit card. They obtained some stock certificates from a financial printer, which cost about $50, and then issued them to themselves. So far, everything was completely legitimate.

The next trick was to get someone to buy them. For that, the fraudsters needed two things. First, they needed a source of investors. For most pump-and-dump fraudsters, including Stocker and Offill, that requires the help of a broker-dealer with clients and access to the markets. Second, they needed a story. Stocker and Offill claimed that their corporations were on the leading edge of some terrific technologies that would make all of their investors rich beyond all visions of avarice. This story was completely made up, which is where the fraud comes in.

Pumping and dumping is just a form of market manipulation. Usually, two people will buy and sell the stock to each other to get some volume on the tape. Some incautious investors (otherwise known as "suckers") see the volume, assume that something interesting is going on with the company, and invest. Then the manipulators back away and sell at the pumped-up price, leaving the market to collapse. This is a lot easier to do in modern electronic markets than it used to be. The manipulators usually get some help from a broker-dealer, who collects commissions, looks the other way when suspicious orders are submitted by the manipulators, and in some cases even participates in the manipulation.

For an initial investment of a few hundred dollars, Offill and Stocker walked away with millions of ill-gotten gain. Naturally, most of this was required to be surrendered to federal authorities in connection with their conviction and sentencing.

One might ask what the regulators were doing when Offill and Stocker were busy committing securities fraud and manipulating markets. The fact is that throughout this entire sorry episode, no one was required by any existing law to make anything other than notice filings with any securities regulator, state or federal. Private securities offerings in most cases can be made without any filing with a securities regulator. Regulators rarely check to see if notice filings have been made.

Broker-dealers can quote the stock if they receive a client order, even if the stock is not registered and even if no filings have been made. The first broker-dealer to quote the stock without a client order must file a Form 211 with FINRA, but it is very difficult for FINRA to determine, based on the information filed with a Form 211, whether or not the stock was issued in a bona fide private offering. Fraudsters generally are not reluctant to provide bogus information to a broker-dealer for purposes of making a Form 211 filing, and can usually find a broker-dealer hungry enough, or avaricious enough, to make a Form 211 filing without too much fact checking.

Unfortunately, Offill and Stocker are not the only pump-and-dump artists in the news recently. On April 27, 2010, the day after Offill was sentenced, FINRA fined Fagenson & Co., RBC Capital Markets Corporation, Alpine Securities Corp., Equity Station, Inc., and Olympus Securities, LLC, a total of $385,000 for their participation in the distribution of the shares of Universal Express Inc., another fraudulent scheme that netted proceeds of $8.4 million for its perpetrators.

The financial services reform bill, called "Restoring American Financial Stability Act of 2010," which currently is being debated in the Senate, would make pump-and-dump schemes a lot harder to pull off, and make it much easier for law enforcement officials to track down the manipulators.

The Act would require the SEC to decide whether or not certain types of private offerings of securities will be required only to submit state filings as "non-covered offerings." Issuers making private offerings that are "covered offerings" will be required to file their offering documents with the SEC. If the SEC reviews the offering documents within 120 days, state regulators may only require a simple notice filing. If the offering is non-covered, or the SEC does not review the offering documents within 120 days, it will be subject to filings with state securities regulators. One way or the other, all offerings of securities will be subject to review by some securities regulator, either at the state or federal level.

My guess is that state securities commissions will be under a lot of pressure to conduct reviews of offerings that the SEC allows to pass without review. To pay for all this, we can expect state legislatures to impose substantial filing fees.

This provision, if it survives, would be a huge change in the way private offerings are conducted in the United States. Most interests in hedge funds currently are sold pursuant to Rule 506 under the Securities Act of 1933, which requires only that notice filings be made with the SEC and with the states in which the securities are sold. No securities regulator reviews a hedge fund's offering documents, unless an investigation is conducted, and the SEC or a state Attorney General subpoenas them.

Moreover, the SEC today only reviews a fraction of the securities offering documents that are filed with it in public offerings. When the SEC does review documents, the offering is delayed, and the SEC reviewers often have questions, or insist on additional disclosures or clarifications. An intensive review process will be an entirely new, and I suspect, most unwelcome experience for most issuers of private offerings.

A filing and review requirement for every offering document will also facilitate the creation of a database of securities offerings. When a broker-dealer wishes to offer a quote in a public quotation system, regulators should be able to determine immediately where the initial offering documents were filed and reviewed. Once this happens, FINRA will be able to refuse to issue symbols for securities offered privately without a filing and review by some securities regulator. The system can easily be bolstered with public support by requiring offering documents for publicly traded securities to be made publicly available in an Internet repository, such as the inexpensive facility maintained by Pink OTC Markets. Without a symbol, broker-dealers cannot make trade reports or submit quotations into publicly traded venues. Pump-and-dump schemes will be a lot harder to pull off.

There have been many efforts over the years to do something about blatant fraud in the OTC markets. Usually, they have involved some effort to make broker-dealers perform due diligence on the offering or before submitting a quotation into a public quotation venue. Broker-dealers are not permitted to charge issuers for due diligence, which means that they must expect to make enough on commissions to pay for the effort. To state the obvious, compliance officers at broker-dealers often are under great pressure to perform as minimal a review as possible. Broker-dealers without a strong culture of compliance may perform no due diligence at all and thus provide an attractive place to do business for fraudsters.

It is much more sensible to require instead that regulators track securities offerings and their progress in the markets. It makes a great deal of sense to try to prevent the fraudsters from getting into the markets in the first place, rather than relying solely on enforcement efforts after-the-fact. However, the additional regulatory review will raise the cost of private offerings significantly. It all boils down to a trade-off: while regulatory review will make private offerings more expensive, it also should cause investors to be more confident of the legitimacy of private offerings and more willing to make investments in privately offered securities. That should make it easier for legitimate issuers to raise capital.

If some version of the Restoring American Financial Stability Act makes it through Congress, we will embark on an experiment with more intensive regulation of capital markets than we have seen in recent decades. It will be interesting to see whether the experiment lives up to its promise.

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