The Ralston-Landreth-Gustafson Harmony: A Security!

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Abstract: The legal definition of a security is incomplete but consistent with the economic function of securities transactions and the financial theory of securities valuation (the Capital Asset Pricing Model). The switch of the regulatory environ-

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ment from buyer beware to seller disclose is justified because buyers lack access to information and control. Despite that this analysis makes Landreth and Ruefenacht appear questionable, the regulation of private sales of securities that arises from Rawlston Purina, Landreth, and Gustafson is superior to what the drafters of the ’33 Act could have anticipated.

I. INTRODUCTION

A security is “any[thing] known as a ‘security.’”1 Of all the weak foundations on which to build a statutory scheme of regulation, this may be the weakest from the perspective of logic yet one of the most durable in terms of functionality.

While many regulatory schemes determine their application by a definition, the securities laws’ definition is unusual. The statutory text of the definition could serve as an illustration of circular logic, defining a security with a long list of specific transactions and closing with “any[thing] known as a ‘security.’” The courts, groping for a definition, have latched on the words “investment contract” that appear within this laundry list. This supposed definition is unclear and unprincipled. Unsurprisingly, the courts have sharply disagreed on its interpretation. Closer scrutiny reveals that the definition is incomplete because it turns on imputed motive from unspecified facts.

The passage of time, however, has produced a uniquely powerful ally to this definition, the development of finance theory. This article takes the lessons of finance and offers a principled approach to the definition of a security. The juxtaposition of the analysis to the caselaw reveals a paradox. While securities law proceeded with the wisdom of placing substance over form till the late eighties, the Supreme Court deviated and placed form over substance in 1989 when it rejected the sale of business doctrine. Although the Court restored the consequences of the sale of business doctrine in 1995, it did so without expressly restoring the supremacy of substance over form.

Part II of this article discusses the caselaw of the definition of a security. Part III analyzes the caselaw to find the definition’s functional role. Part IV presents finance theory and finds its analysis harmonious with that of the legal analysis. Part V explores the history of the sale of business doctrine, its reversal and its implicit reinstatement by Gustafson. Part VI argues that the resulting regime works and Part VII concludes.

II. THE CASELAW OF INVESTMENT CONTRACT

Whether something is a security is of enormous importance. Under securities law, the buyer has the right to rescind the purchase if the seller has failed to disclose all the material attributes of the security,\(^2\) sellers and those facilitating the sale are subject to expansive liability for false statements,\(^3\) and issuers of securities are subject to obligations to disclose,\(^4\) restraints on trading,\(^5\) and face heightened anti-fraud liability.\(^6\) Ordinary contract law, by contrast, follows the principle of “buyer beware.”\(^7\) Barring special regulation such as lemon laws,\(^8\) neither sellers nor intermediaries have obligations to speak.\(^9\) Buyers obtain the right to rescind contracts in...
very limited circumstances. Liability in deceit is much more difficult to establish.

The statutory definition of a security is frustratingly circular (including “any[thing] known as a ‘security’”), vague (including “investment contract”) and long (spanning over one hundred and thirty words, for example, in the federal definition in the Securities Act of 1933).

In interpreting the federal definition of a security, the United States Supreme Court has focused on “investment contract” and has visited the issue in numerous opinions. The opinions bracketing the issue with the greatest generality are Howey and Forman.

10. See I Farnsworth on Contracts §§4.11-4.15 (2004) (discussing the requirements for rescission based on misrepresentation: must be fraudulent or material, promisee must have relied on the assertion, the reliance must have been justified, and the contract must not have been “ratified”).

11. Restatement (Second) of Torts § 551, cmt. a (“Unless he is under some one of the duties of disclosure stated in Subsection (2), one party to a business transaction is not liable to the other for harm caused by his failure to disclose to the other facts of which he knows the other is ignorant and which he further knows the other, if he knew of them, would regard as material in determining his course of action in the transaction in question.”).

12. Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b (2011), defines a security: The term “security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, or any certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. (emphasis added)


Buyers of land in *Howey* were held to be buyers of securities. Buyers of shares in *Forman* were held to be buyers of land.

The sellers of the alleged securities in *Howey* entered into two transactions with each buyer, a land sale and a service contract.\(^{16}\) The land sale transferred to the buyer a segment of a citrus grove. The service contract gave the seller the exclusive right to cultivate and harvest the citrus grove, commingling the fruit with that of the rest of the grove, while the buyer would receive a monetary return based on the buyer’s fractional interest in the greater grove. The sellers claimed they sold land. The buyers argued that they bought securities.

Focusing on the definition of a security as an investment contract, the Court interpreted it to mean “investment of money in a common enterprise with the expectation of profit solely from the effort of others.”\(^ {17}\) Did *Howey* buyers invest with the expectation of profits from the effort of others or did they buy land? The Supreme Court concluded the former. Therefore, the *Howey* buyers bought securities rather than land.

In *Forman*, the buyers acquired shares in a condominium cooperative and signed a lease for a specific unit.\(^ {18}\) Each share purchase entitled the buyer to a specific unit and to fractional ownership of some aspects of the building complex.\(^ {19}\) The buyers received the benefit of reduced rent due to income from leases of common areas.\(^ {20}\)

The Second Circuit saw *Forman* buyers as akin to *Howey* buyers.\(^ {21}\) While the sellers claimed that the buyers purchased the right to live in an apartment, the object of the transaction was shares. Furthermore, the buyers did have financial consequences from a common enterprise, the rent collected by the association for leasing the common spaces. The Supreme Court, however, overrode the form of the transaction as a purchase of shares and held that the *Forman* buyers did not receive securities. Although monetary consequences from a common enterprise did flow to both *Howey*

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20. *Id*.
and *Forman* buyers, only *Howey* buyers were motivated by an “expectation of profit.”  

The Supreme Court distinguished *Forman* from *Howey* based on the buyers’ motivations. The focus on motivations is misleading because the court drew a legal rather than a factual conclusion. The court did not interpret the facts *de novo* to learn what the actual motivation of the buyers was. Rather, the court interpreted the facts to draw a legal conclusion which imputed a motivation to the buyers. The Supreme Court concluded that, as a matter of law, the *Forman* buyers’ motivation was different than that of the *Howey* buyers. The investment contract definition does not identify what exact facts lead to one imputation versus the other. The essence of the security definition is the identification of the facts that lead to the different imputation of motive. Yet, the investment contract definition is conclusory because it does not help establish what facts should lead a court to conclude that buyers are motivated by a desire to invest in a common enterprise with the expectation of profit primarily from the effort of others.

In sum, the definition of a security as an investment contract makes little progress. The definition of a security is still a cipher. The next section tries to interpret the investment contract definition from a consequentialist perspective.

### III. THE FUNCTION OF INVESTMENT CONTRACT

Ideally, the “investment contract” definition of a security is consequentialist rather than essentialist.  

A consequentialist definition of a security is justified by its consequences whereas an essentialist definition would match some essence or truth. The consequentialist definition would be motivated by its consequences.

The security definition results in the switch from the “buyer beware” regime of contract law to the “seller disclose” of securities law. If the definition is consequentialist then the facts that lead courts to impute the motivation to “invest in a common enterprise with the expectation of profit from the effort of others” should relate to the purpose of the change of legal regimes. These facts should

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24. See supra, text accompanying notes 2-11.
relate to the propriety of the “buyer beware” legal environment for *Forman* buyers and its impropriety for *Howey* buyers. A closer examination of motivations reveals the salient facts.

Compare the motivations of an ordinary buyer of land to those of the buyers in *Howey*. An ordinary buyer of land tends to care about unique features of the object of the transaction. Buyers of land ordinarily care about aspects such as its location, accessibility, the composition of the soil, access to water, or the health of its trees. The *Howey* arrangement, however, overrode entirely this subjective evaluation of each buyer’s land. Rather, the buyers’ sole motivation for the purchase was financial participation in a fraction of the profits of the greater citrus grove, the common enterprise. Each buyer, instead of assessing the offered property’s match to the buyer’s preferences, assessed the financial appeal of the collective project.

Crucially, each buyer of land typically would be able to determine the appeal of a piece of land for that buyer’s own use: the buyer could evaluate the land’s features to comport with that buyer’s own satisfaction. By contrast, the buyer of a fractional interest in the collective project of the *Howey* citrus grove could not assess it by merely evaluating the offered land. The common enterprise changed the size and nature of the buyer’s analysis of the object of the transaction.

Since the buyer’s return depended on the aggregate harvest, the buyer needed to draw conclusions about aspects of the common enterprise. The buyer’s return depended on the health and productivity of trees that were not on the buyer’s land. Compared to an ordinary land sale, what a *Howey* buyer should inspect changes in size. The *Howey* buyer would have to inspect the entire grove instead of only the offered land.

The common enterprise also changed the nature of the buyer’s future involvement. Whereas the buyer of one acre of land would determine the buyer’s own ability to manage that acre, the *Howey* buyers had to determine the prospects of the *Howey* management in the broader market for citrus products. The buyer’s efforts will determine the future of an acre in a true land sale. The buyer’s own efforts could have no effect on the management of the *Howey* grove.

Whereas buyers of land tend to inspect the offered land and bear the risk of their own administration, buyers of fractional
participation in common enterprises tend to have difficulty assessing the greater enterprise and tend to have no control of its management. The regulatory environment of “buyer beware” is adequate for true land sales because it puts the risk on the shoulders of the buyer who must inspect and will administer the property. The “buyer beware” regime is inadequate for sales of fractional participation in a collective project like that of Howey because each buyer can neither appropriately inspect nor will have the control necessary to administer the common enterprise.

The motivation of the Forman buyers was the desire to obtain low-income housing. The buyers sought to characterize the transaction as the purchase of a security in order to avoid subsequent rent increases. The sellers argued that the transaction, in substance, was not a security despite taking the form of a purchase of shares. The Supreme Court concluded that the Forman facts did not involve a security. Thus, the Supreme Court reversed the Second Circuit, which had focused on the rent reduction from the fractional participation in rents from commercial spaces of the building complex and to conclude that the transactions involved securities.

Because the Forman buyers sought apartments, the linked shares were neither identical nor fungible. In contrast to a Howey buyer, who did not care which trees corresponded to his purchase, a Forman buyer cared which apartment corresponded to his purchase. A Howey buyer did not care about his land’s trees quality but about those of the greater grove, from the pooled product of which he’d receive a fraction. A Forman buyer would live in the apartment and, depending on his preferences for aspects such as silence, accessibility, or view, likely cared a great deal about which apartment corresponded to his shares. A Forman buyer did not have to assess apartments other than the one in which the buyer intended to live.25

The above discussion justifies the distinction of Howey from Forman on the basis of problems that the “buyer beware” legal environment posed for Howey buyers. The Howey buyer had two problems with the contract. First, the buyer could not access the trees beyond the offered acre. The buyer could not access the greater

25. The financial future of Forman buyers, however, did depend on a common enterprise run by others. The success of the common aspects of the enterprise in Forman would influence the financial appeal of the transaction for the buyers by influencing the rent. Nevertheless, those common aspects were not the buyers’ primary motivation and were not sufficient to render the transaction a security.
enterprise in order to evaluate it at the time of the transaction. The quality of the offered acre was irrelevant because every acre entitled its owner to the same fractional proceeds from the enterprise. By contrast, a Forman buyer who visited an offered apartment hardly needed any information about features of rest of the complex in order to decide whether that apartment was satisfactory.

Second, the lack of control of a Howey buyer meant that the buyer’s skills and effort would have no consequence for the future success of the object of the transaction. The future of the grove depended on the skills and effort of the grove’s management. By contrast, the skill and effort of a Forman buyer would directly translate into home décor and warmth.

The two problems for the contract of the Howey buyer become apparent. The Howey buyer has a difficulty of evaluating the object at the time of the offer and a difficulty due to lack of future control.

A. Evaluation Difficulty at Time of Offer

The evaluation difficulty that accompanies securities is a product of control, transaction practice, and collective action problems. A Howey buyer being offered one acre did not have control to access and evaluate the entire grove. The lack of access is not a product of lack of control alone. Buyers on non-securities also lack control over the object of the transaction (until its consummation). However, transactional practice and the parties bargaining power tend to lead to the practice that buyers of non-securities inspect the offered item to their satisfaction.

The collective action problem is a result of the fractional nature of the purchase. A purchaser of the entire grove would decide how much to spend on appraising it in view of receiving its entire value. A lone Howey buyer would not have a right to force other buyers to share any appraisal expenses. Since a Howey buyer would obtain a fraction of the grove, he would have a reduced incentive to spend to appraise the entire grove.

This difficulty of evaluation is cured by switching from the regime of buyer beware to that of securities law. The seller has access to the information and knows that the buyer is interested in nothing but investment returns and their risk. Therefore, the seller is in a perfect position to make a full disclosure.
The seller’s disclosure is also the result of examining this failure of contract law from the perspective of the Coase theorem. In a world with no costs of organizing and trading, all the Howey buyers would act in concert and share the appraisal expenses. Since reality makes that prohibitively costly, the rule forcing the seller to disclose the valuation to each buyer is justified.

**B. Lack of Future Control**

The lack of future control relates to the measures that the buyer can take if the purchase does not work as planned. If conditions deteriorate, an owner who controls a good can attempt to change its use. If the old use is no longer ideal, the good may attain more value in a new use. However, a buyer of a security will have no control over management. Thus, if the management of the combined enterprise will not change its mission, the holder of its securities will suffer the consequence of lower value with no remedy.26

The allocation of the responsibility for maintaining the optimal use of the property follows the allocation of legal responsibility. In the buyer beware environment, the buyer will control the good and will have responsibility for changing the good’s use. In the environment of securities law, the seller maintains control. The economic function of the changed legal regime becomes apparent if we consider a quick change in circumstances. If the management does not adapt to the new circumstances, buyers will exercise the rescission remedy that securities law gives them. So either the harm will return to the seller or the seller will prevent it, ensuring that the incentive to optimize the enterprise’s use stays with the seller who has the control to do so.

In sum, the distinction between Howey and Forman that makes “buyer beware” appropriate for Forman is that Howey buyers have two disadvantages. Securities buyers lack current access to information about the enterprise and they lack control over the enterprise’s future. The legal environment of buyer beware is

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26. State law governs the claims of shareholders for mistreatment, see Santa Fe Ind., Inc. v. Green, 430 U.S. 462 (1977) (shareholders could not use federal securities law to pursue remedies for being mistreated but were confined to their state remedies). State laws treat informed and disinterested decisions by the directors of the corporation as immune under the doctrine of the business judgment rule, see, e.g., David Rosenberg, Galactic Stupidity and the Business Judgment Rule, 32 J. Corp. L. 301 (2006-2007); David Rosenberg, Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule, 6 Berkeley Bus. L.J. 216 (2009). [EDITORS, ADD ANY BJR ARTICLES YOU LIKE]
appropriate for *Forman* buyers because it places the burden on the side of the transaction who will determine its success. By contrast, securities buyers neither have access to the greater enterprise nor have control over its future. Subjecting them to the buyer beware regime does not make sense.

IV. PRICING MECHANISMS

Whereas the courts focus on “investment contract” to define securities, economic theory follows a path that focuses on the forces of supply and demand that produce the price of goods. Both approaches turn on buyers’ motivations but in different ways. Economic theory separates goods subject to subjective valuation and, hence, sloping supply and demand from goods subject to the objective valuation of the Capital Asset Pricing Model, which in turn requires fungibility and exclusively financial use.

One of the primary contributions, revolutions even, of finance theory is the development of a pricing theory for “capital assets.” The Capital Asset Pricing Model was the contribution rewarded by the Nobel Memorial Prize in Economics in 1990.\(^{27}\) For the purpose of securities laws, the instructive question is to attempt to categorize the types of goods that are subject to the Capital Asset Pricing Model (the CAPM) and those that are subject to the conventional pricing mechanism of supply and demand. After a quick review of the two pricing mechanisms, supply-demand and the CAPM, let us turn to determining how they separate goods.

A. Supply-Demand

Conventional economic theory posits that supply and demand establish goods’ prices. The background assumptions are (1) that sellers know how much producing additional units of the good costs them; (2) buyers know how much benefit they derive from using additional units of the good; and (3) both buyers and sellers are subject to diminishing returns, meaning that producing and using additional units becomes costlier, diminishing the gains from trade. That returns are diminishing also suggests that if

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significantly fewer of the good were made, those would be cheaper for the sellers to produce whereas they would give greater benefits to buyers. Vice versa, if significantly more of the good were made, they would become increasingly costly to produce while becoming decreasingly useful to buyers.

This setting of supply and demand produces the economic ideal of “equilibrium,” Latin for balance. If either too few or too many of the good are made, buyers or sellers would regret their decisions. The equilibrium of supply and demand occurs when the price of the good induces the production of the same number of goods as the number consumed. In that equilibrium no seller and no buyer regret their decisions. None would like to have acted differently in their decisions to produce the good or buy the good.

Best examples of goods subject to supply and demand would be handcrafted goods that are either perishable or costly to store. Use woven baskets as an example. Basket-weavers have limited time and alternative uses for their time. They can easily produce some reasonable number of baskets but producing more becomes increasingly costly. Buyers of baskets have a strong need for the first few baskets for carrying their things but buying more baskets fast becomes wasteful. The pricing theory of supply-demand tells us that the market price of baskets is such that an equilibrium of no regrets obtains. Weavers weave as many baskets as buyers want because of pricing.

If weavers wove too few, buyers would create a shortage in the market. Users who derive great value from baskets would ask for more and would be willing to pay high prices for them. This would attract more weavers into making more baskets.

If weavers wove too many baskets, buyers would not buy them all. The market would experience a glut. The perishability of the good now becomes important for the sellers’ reaction to the glut because perishability means the sellers cannot wait by storing their unsold stock. If baskets were completely perishable, meaning that they would eventually become worthless, then weavers become willing to cut prices dramatically, essentially accepting any price. Weavers would cut prices to attract the buyers who derive low benefits from baskets. The surprisingly low price means some do regret their actions. The weavers who have the highest costs or greatest alternative opportunities would prefer not to have woven as many baskets.
The lack of an equilibrium in the case where too many or too few goods were produced tends not to persist. Those who regret their past conduct, change it until an equilibrium occurs.

B. The Capital Asset Pricing Model

The science of finance offers a different mechanism for the pricing of stock, the Capital Asset Pricing Model, CAPM. The CAPM does not deny supply and demand. Rather, it predicts the price that supply and demand will produce.

The CAPM, pronounced cap-EM, is a massive intellectual tower with foundations in probability theory and statistics. Oversimplified, the CAPM makes two giant steps. From the history of the prices of each stock a statistical method named regression calculates a measure of the type of undiversifiable risk about which investors must and do care. From that measure of risk, the CAPM determines the appropriate rate of return that investors ought to expect from each stock. That the CAPM determines the appropriate return for each risk, also means that the CAPM can price each risk using that return.

To understand the CAPM one must understand several profound concepts from statistics and finance: (i) risk and its measurement through average deviation or standard deviation, (ii) that, whereas diversification can reduce as much as we want the risk from independent gambles, diversification fails to have the same effect in stocks, reaching a floor below which it cannot reduce risk and that the economic explanation of that failure is the common risk of the performance of the entire economy and that this is appropriately approximated by a broad market index, and (iii) that beta is the statistical measure of the tendency to change in a constant relation with the stock index that the regression method produces.

1. Risk

Before the resolution of uncertainty, its outcome is not known. Experience with some types of uncertainty shows that they are different, even if both the range of outcomes and the average outcome are the same. Take the uncertainty of gambling on fair, 50-50, double-or-nothing coin tosses. Placing one’s entire purse on a single coin toss is different than dividing it into two or four equal
bets on different coin tosses. The range of outcomes is the same. The range starts from losing everything to reach doubling one’s purse. The average outcome is the same. While some bettors may lose all their purse and some may double it, in aggregate, bettors will tend to win about as much as they bet because they will tend to win about half the tosses.

Yet, some bettors can plan while others cannot. Take bettors who place their entire purse on a single coin toss. With 50% probability they will lose the entire purse. They cannot expect to meet with the purse funds any obligation they undertake. Bettors who split, however, the purse into many smaller bets, will be able to plan significant expenditures out of the purse money and meet them with near certainty. They expose their purses to different risks despite the same range and average. For the purpose of understanding the CAPM, risk is best measured by “dispersion” according to the probability theory branch of mathematics. Measures of dispersion seek to convey a metric of how much the actual outcomes will tend to differ from a metric of the centrality of the outcomes, such as the average or median.

Measures of dispersion come in various flavors. Standard deviation is the most famous but also the least pleasant. It is famous because its mathematical properties allow easy manipulation in equations. It is unpleasant due to its reliance on square roots that make it void of any intuitive appeal. Average [absolute] deviation and median [absolute] deviation are more intuitive. They answer the questions, respectively, what is the average distance from the average and what is the median distance from the median (with distance measured in absolute terms, dropping negative signs). The choice of a measure of dispersion makes little difference in understanding the CAPM. Groping for some intuitive appeal, let us use average deviation.

Average deviation is the average distance from the average, in absolute terms, i.e., dropping negative signs when averaging (otherwise outcomes above the average would cancel those below). To illustrate continue the coin tossing example. Suppose the purse is $1,000. Gambling the entire purse on a single toss would lead to a win with 50% probability and winnings of $2,000 whereas it would lead to a loss with 50% probability and winnings of zero. The average outcome is $1,000 (.5 times 2,000 plus .5 times 0). Average deviation is $1,000 because with 50% probability the absolute
difference is 1,000 (from the +1000 difference of the outcome of 2,000 to the average of 1000) and with 50% probability again 1,000 (from the -1000 difference of the outcome of zero to the average of 1000).

Splitting the purse into two, betting $500 on each of two coin tosses, changes average deviation but changes neither the range nor the average outcome, which stays $1000. To win $2,000, both tosses must be wins. The first is a win with 50% probability (half the time) and then the second must also be a win. Two wins happen half the time of half the time, .5 times .5, i.e., with 25% probability. The outcome of zero, similarly, occurs with 25% probability. The remaining 50% of the time, the outcome is either a win followed by a loss or a loss followed by a win, for a final outcome of $1,000 with 50% probability. The second toss makes average deviation much smaller. Average deviation is $500 because with 25% probability the absolute difference is 1000 (from the +1000 difference of the outcome of 2,000 to the average of 1000), with 50% probability the absolute difference is zero (from the outcome of 1000 to the average of 1000), and with 25% probability the absolute difference is 1000 (from the -1000 difference of the outcome of zero to the average of 1000).

The change in average deviation corresponds to an important change in the uncertainty. When taking the second bet on the second coin toss, half the time the bettor walks away with the average. The remaining half of the time the bettor ends up with a difference of $1000 from the average. In the bet on the single coin toss, the bettor is certain to be always $1000 away from the average.

In sum, measures of dispersion, such as average deviation, are appropriate measures of risk because they explain the difference between uncertainties despite that the uncertainties may have the same ranges as well as the same averages.\(^{28}\) Betting the $1,000 purse on a single coin toss or splitting it among many coin tosses, on average and in the long run, does not make a difference.

\(^{28}\) More statistical measures may explain even more but dispersion is enough for understanding the CAPM. Additional statistics may allow differentiation between risks that have both the same average outcomes as well as the same average deviations. While one could counter that the range of the uncertain outcome is the most important for (preventing) planning, the importance of range is undermined by the fact that most continuous distributions have infinite range. Since any plan can be foiled by a sufficiently major adversity, the best measure of what prevents planning is a measure of the likely size of the adversity, in other words, the likely deviation from the expectation, which is what dispersion measures convey.
However, the individual’s ability to plan a future expense of, say, $300 out of that purse is vastly different. With a sufficiently small dispersion, the individual can commit to the expense. Someone who wants to plan with great certainty, will stay several multiples of this measure away from any uncertainty that may foil plans. The “six sigma” quality control principle, for example, advocates staying six standard deviations away.\textsuperscript{29}

Understanding that measures of dispersion, such as average deviation, measure risk, is important because it helps understand how diversification can reduce risk in gambles. When applied to stocks, however, diversification reaches a limit below which it cannot reduce risk. Understanding this failure of diversification is necessary to understand the CAPM.

2. \textsc{Diversification}

Diversification is the reduction of the amount exposed to each risk while increasing the number of risks. The gambler who splits the $1000 purse into two bets of $500 each is diversifying and does even more so by splitting it in ten gambles of $100 each. The entrepreneur who sells a million dollar stake in a new business and invests $10,000 in each of one hundred different corporate stocks is also diversifying. The smaller risks have the same risk profile as the initial larger one. The total amount at risk remains the same but the aggregate risk drops.

Two phenomena cause the risk drop due to diversification. Risk drops because not only diversification makes extreme outcomes become less likely but also because diversification creates more central outcomes, near the average. Diversification makes extremes less likely because all the different independent risks must produce the same outcome (all wins or all losses) for extreme outcomes to occur, which becomes increasingly unlikely as diversification increases. Moreover, diversification increases the number of outcomes near the average. The operation of diversification was visible in the example above, the split of the $1000 purse into two bets of $500. Rather than look at the split of the purse into

four, let us jump ahead and split the purse into ten bets of $100 each.

When our bettor splits the $1000 purse into ten bets of $100 on fair 50-50 double or nothing coin tosses, the range of outcomes remains $0 to $2,000. Diversification makes the extreme outcomes more unlikely and adds additional outcomes, since possible outcomes are all the multiples of $100 from zero to two thousand. Reaching the extremes is much less likely than when splitting the purse in two. Winning all ten or losing all ten happens with probability less than one in one hundred thousand. Similarly, despite that winning only one would be a terrible outcome, that is also extraordinarily unlikely (as is ending with $1,900). Simultaneously, the diversification produces additional outcomes near the average of $1,000. Namely, the diversified bettor may end up with $900 or $1,100, merely $100 away from the average, or with $800 or $1,200, merely $200 away from the average. By producing more outcomes near the average, diversification increases the cumulative probability of ending near the average. Both the reduction of the probability of extremes and the accumulation of probable outcomes near the mean, combine to reduce risk.

The reduction in average deviation confirms the reduction of risk. Moving from betting the entire purse of $1,000 on one toss to betting it on two tosses reduced average deviation from $1,000 to $500. Betting it on ten tosses reduces average deviation to $246.09. Betting it on a hundred $10 tosses reduces average deviation to $79.58, and betting it in a thousand $1 tosses reduces it to $25.22. If there is no lower limit on the size of the gamble, diversification can reduce dispersion below any given number.

To compare diversification in independent gambles to that in stocks, switch from absolute numbers to percentages. Generalize the example by transforming average deviation to a fraction of the purse. Betting the entire purse in single toss produces average deviation equal to the amount of the purse, 100%. Splitting the purse to

30. The bettor wins the first toss half the time. The bettor wins both the first two tosses half the time of half the time. The bettor wins all ten tosses half the time of half times, or \( \frac{1}{2} \) raised to the 10\(^{th}\) power, namely once in one thousand twenty four or with 0.00097% probability.

31. While the formula for average deviation frustrates the manipulation necessary to solve for the desired average deviation, this is easy for standard deviation. The standard deviation, \( s \), for the number, \( n \), of independent, 50-50 gambles in which a purse of dollars, \( p \), is divided simplifies to \( s = \sqrt{np} \) which, solved for \( n \) gives the number of tosses that produce the desired standard deviation \( s \), namely \( n = (p/s)^2 \).
two tosses reduces average deviation to 50%, whereas dividing it over ten tosses brings average deviation to 24.6%. One hundred tosses reduce it to 8%, one thousand to 2.5%. Diversification in stocks cannot bring deviation that low.

3. LIMITATION OF DIVERSIFICATION IN STOCKS

Stocks do not behave like coin tosses. The experience with diversification in the stock market is sharply different. Diversification does not reduce deviation below a floor near 20%.32 Diversifying over the 500 stocks of the Standards & Poors 500 index, as diversifying over the thousands of stocks of indices that are even broader, reaches the same stumbling block. Stocks do not behave like coin tosses. Despite having diversified, the investor still carries substantial uncertainty.

Despite not behaving as nicely as diversification among gambles, diversification in stocks still has a very significant effect. A diversified portfolio does have much less risk than an undiversified one. The puzzle is why diversification among stocks has a reduced effect.

Finance theory solved this puzzle by realizing that risks for stocks divide into two categories, risks about specific businesses and risks about the entire economic system that influence all businesses. Examples of the former, known as firm-specific or idiosyncratic risks, are the health of senior executives, the success of products and innovations of each business and its competitors, or accidents to the business’s productive resources. Examples of the latter, known as market-wide or systematic risks, are wars, social unrest, or economic crises.

Diversification among stocks only operates on firm-specific risk and has no effect on market-wide risk. When the investor diversifies by dividing a portfolio among many stocks, the good luck in firm-specific risks of some firms will tend to cancel out the bad luck of others. This diversification, however, does not help the investor avoid the consequences of general recessions and panics. Those will hurt the prospects of all firms and have a full impact on investors, however diversified.

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4. Measuring Undiversifiable Risk

The next task of the CAPM is to establish how sensitive each stock is to this undiversifiable, market-wide risk of the entire economy’s performance. Ideally, finance would do this by computing the sensitivity of each stock to changes in the economy. Several metrics of the economy’s performance exist, such as the gross national product, productivity change or inflation. Those, however, are neither conclusive nor observable immediately. Because changes in the economy are not observable, finance finds a substitute that is sensitive to changes of the economy and calculates the sensitivity of the changes of each stock’s price to the changes of the price of the substitute. Financial practice uses a broad stock index as the substitute gauge, usually the S&P500 index.33

Measuring how sensitive each stock is to the index is an application of the linear regression statistical method. Linear regression derives the equation that draws the line closest to a set of points on the Cartesian plane, what spreadsheets call a trendline.

Figure 1 offers an example of three points and the trendline that linear regression produces and adapts to stocks. Two axes provide the coordinates that identify points on the plane, the horizontal axis or x-axis and the vertical axis or y-axis. The CAPM places on the horizontal axis the performance of the index and on the vertical axis that of the stock. Each point corresponds to a pair of numbers, that point’s coordinates, conventionally in a parenthesis with the horizontal or x coordinate first, (x, y). The figure shows three points, (.8, .8), (.2, -.3), and (-.6, -.6). In the context of its application for the CAPM, those would correspond to three time periods, one when the index rose .8 while the stock also rose .8, one when the index rose .2 while the stock dropped .3 and one when they both dropped .6. Linear regression calculates the coefficients of an equation that draws the straight line nearest to those points. The equation calculates the y that corresponds to each x by using a coefficient multiplied by x plus an other coefficient. The one multiplied by x is often symbolized by the letter beta and the other by alpha, so that the equation is $y = \beta x + \alpha$. In the figure’s example,

33. The S&P500 is an index that aggregates the prices of the stock of five hundred large publicly traded corporations, adjusting for the capitalization of each firm, so that large firms have proportionally more weight than small ones. See STANDARD & POOR’S 500 GUIDE (2012); S & P INDICES: S & P 500, http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usd---p-us-l-- (last visited June 12, 2012).
linear regression produces the equation $y = 0.9662x - 0.1622$. In the CAPM, the $x$ corresponds to the index and the $y$ to the stock.

**Figure 1: Cartesian Plane and Trendline**

The CAPM considers that the beta coefficient captures the tendency of the stock to change with the economy (the CAPM ignores the other coefficient, alpha, mostly because in a diversified portfolio the alphas should cancel out). Rather than coin a new name for this measure, finance refers to it as beta. Beta is the tendency of each stock to change with changes of the index. A beta of 1, for example, means that the stock tends to change as much as the index, a beta of a half indicates the tendency to change half as much and a beta of two twice as much.

Figure 2 illustrates the calculation of the beta of two stocks. The weekly prices of the maker of electronic games Activision Blizzard, Inc. (stock symbol ATVI) against the S&P500 form the left panel. Those are the prices for the thirty weeks ending October 28\textsuperscript{th} 2011 [EDITORS: May elect to only have them on my website] and also appear in Appendix A.\textsuperscript{34} For comparison, Prudential Financial, Inc. (stock symbol PRU) produces the right panel. Linear regression produces the trendlines. Activision Blizzard’s trendline corresponds to the equation $y = 0.6229x + 0.0074$ and Prudential’s trendline corresponds to $y = 1.5265x - 0.0003$. Activision Blizzard has a beta of about .6 and tends to change about 0.6 as much as the

\textsuperscript{34} The spreadsheet is available at my site, www.nicholasgeorgakopoulos.org under this article’s title in the publications page.
index whereas Prudential has a beta of about 1.5 and tends to change about 1.5 as much as the index. (That neither stock changes in lockstep with the index is an expression of the idiosyncratic risk of each stock; each week, the unfolding of events has a different impact on the index than on each specific business.)

Figure 2: Price Changes of Stocks Against Index

A diversified portfolio would minimize idiosyncratic risk. Even a diversified portfolio, however, would remain exposed to the uncertainties of the entire economy. However, a diversified portfolio of stocks that are like Activision Blizzard in their sensitivity to surprises for the economy would tend to change less than a diversified portfolio of stocks similar to Prudential. A diversified portfolio of stocks like Activision Blizzard would tend to change about half as much as the index whereas a diversified portfolio of stocks like Prudential would tend to change one-and-a-half times the index. Both portfolios have diversified idiosyncratic risk but produce a different exposure to market risk. How should the returns of those two portfolios differ? The CAPM answers by giving the return that corresponds to each beta.

5. Pricing Undiversifiable Risk

The components of the Capital Asset Pricing Model mesh together by asking what should be the relationship between the expected returns of two portfolios with different beta. More risk, a larger beta, means a portfolio is less appealing unless it offers a sufficiently higher return to compensate for the greater risk.
Analogously, portfolios with betas lower than that of the market need offer less than the expected return of the entire market.

The CAPM anchors its analysis on two rates of return, the return to investing in the market and the return to safe lending. The market return is the expected return of the entire stock market, such as the expected return of the S&P500 index. Finance theory considers that the safe lending or risk free return is the return that short term government obligations offer, such as treasury securities. The market’s return, however, must compensate for risk. It must be higher than the risk free return. The difference by which the market return exceeds the risk free return is the market premium.

The risk free return is important as a lower bound. Even utterly safe portfolios, invested in treasury securities, earn a positive return (even if nowadays negligible). Any risk should push returns higher than that. The amount of additional return corresponding to each risk should be analogous to the additional return that the market offers. Risk less than that of the market should require a return between the risk free return and that of the market. More precisely, a risk that is a known fraction of that of the market should offer a return that exceeds the risk free rate by the same fraction of the market premium.

A stock portfolio exposing its holder to half the market risk ought to command more than merely half the return of the entire market. All portfolios are entitled to the risk free return and, beyond that, according to their beta, a corresponding fraction of the market premium. Thus, a portfolio that exposes its holder to half the market risk should give a return equal to the sum of the risk free return plus half the market premium.

The same analysis applies to portfolios with risks greater than that of the market. Consider a portfolio with a beta of one and a half. It must earn the risk free return and it must also earn one and one half times the market premium.

The Capital Asset Pricing Model shows that every asset with a known beta has an expected return equal to the sum of the risk free return plus beta times the market premium.\footnote{Formally, the CAPM is }\[
E(R_p) = R_f + \beta(R_m - R_f),
\]

The CAPM is not merely a logical construct. If prices were to deviate from the pricing that the CAPM indicates, that would give rise to opportunities for riskless profit, arbitrage opportunities.
If a diversified portfolio with a given beta offers a different expected return than that indicated by the CAPM, traders can construct synthetic portfolios and create arbitrage opportunities. Understanding the arbitrage that forces prices to comply with the CAPM explains the connection of the CAPM to supply-demand.

The illustration of the arbitrage opportunity requires detail on rates of return. Suppose the risk free return is 1% and the expected market return is 11%, making the market premium 10%. The CAPM indicates that a portfolio with a beta of half should have an expected return of the risk free 1% plus half the market premium, namely an expected return of 6%. Similarly, the CAPM indicates that a portfolio with a beta of one and a half should have an expected return of the risk free 1% plus one and a half times the market premium, namely an expected return of 16%. To observe the arbitrage opportunities, consider four diversified portfolios, a pair at each beta, one with a return lower than the CAPM and one with a higher one. Thus, consider diversified portfolios that have (i) a beta of .5 and return of 4%; (ii) a beta of .5 and return of 8%; (iii) a beta of 1.5 and return of 14%; and (iv) a beta of 1.5 and return of 18%. The existence of any one of these portfolios gives rise to an arbitrage opportunity.

The arbitrage opportunities arise because traders can synthesize portfolios with betas that they desire. Traders synthesize betas by combining (risk-free) lending or borrowing with investing a fraction of their target funds in the portfolio. Thus, an investor who desires a beta of half can, instead of finding stocks with betas near half, invest half the portfolio in the index and half in the risk free security. This portfolio will produce the return that the CAPM indicates for a beta of half because half the money will earn the expected market return (which is the risk free return plus the market premium) and the other half of the money will earn only the risk free return. The synthetic portfolio also has the risk of beta half. If the market has a surprisingly good or bad event that moves the market by any deviation from the expected return, the synthetic portfolio will experience half that impact, just as would the portfolio with the actual beta of a half.

Portfolios with betas greater than one can either be synthesized using borrowing or they can serve as basis for synthesizing the market portfolio by combining them with risk free lending. A synthetic portfolio with beta of one and a half results from
borrowing an amount equal to half of the portfolio and investing the entire proceeds, one and a half times the portfolio amount, in the market index. However, the actual one and half beta portfolio can also help to synthesize a beta one portfolio. The synthetic beta one portfolio has two thirds of its funds in the portfolio with actual beta of one-and-a-half and the remaining one third at the risk free security.

Start with the portfolio with beta of 0.5 and expected return of 4%. The CAPM indicates that such a portfolio should have a return of the risk free rate of 1% plus half the market premium of 10%, namely 6%. The portfolio offers too low a return at its current price and the CAPM would justify a lower price for it. Traders can take advantage of its high price by selling it (perhaps selling it short) and using the market portfolio to synthesize a portfolio with beta of a half. To synthesize beta half, traders place half the portfolio’s amount in the market index and lend the other half at the risk free rate. The resulting portfolio would react to risk like a portfolio with beta half but would have a higher return than 4%. After arbitraging by buying the cheap, in this case the synthetic portfolio, and selling the dear, in this case the actual beta half portfolio, the trader will enjoy a risk free expected return of 2%.

Consider next the portfolio with beta of 1.5 and expected return of 18%. The CAPM indicates such a portfolio should have a return of the risk free rate of 1% plus 1.5 times the market premium of 10, namely 16%. The portfolio offers too high a return at its current price and the CAPM would justify a higher price for it. Traders can take advantage of its low price and use it to synthesize a beta one portfolio while selling (perhaps selling short) the actual

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36. This portfolio will offer a return equal to 1.5 times the market return, namely 1.5 times the risk free return plus 1.5 times the market premium. When repaying the borrowed funds, the portfolio will owe interest computed (hopefully at near the risk free rate) on half the portfolio amount (hopefully near .5 times the risk free return). Surprises to the market have the expected 150% impact on this portfolio. On a period that the market has some deviation from its expected return, the synthetic portfolio will have 1.5 times the market’s deviation.

37. For example, if the trader’s portfolio were $300,000, then the trader would place $150,000 in the beta 1 portfolio that has an expected return of 11% and $150,000 in the risk free asset for a return of 1%. The entire portfolio has a return of 6% (instead of the 4% of the actual beta half portfolio). If the market deviates by any percentage from its expected return, the expected deviation of the synthetic beta half portfolio would be the half that deviation. If, for example, the market were to deviate by 10%, the actual beta half portfolio would tend to deviate by 5% and the synthetic beta half portfolio would also deviate by 5%.

38. The synthetic portfolio has an expected return of 6% and the trader earns that. The actual beta half portfolio has an expected return of 4% and the trader sold it, therefore has given it up or owes it. This 2% difference matches the size of the error.
beta one portfolio. To synthesize beta one, with two thirds of the portfolio the trader would buy the beta one and a half portfolio and lend the remaining one third at the risk free return. The resulting portfolio would behave as a beta one portfolio but would have a higher return. After arbitraging by buying the cheap, in this case the synthetic portfolio, and selling the dear, in this case the market, the trader will enjoy a risk free expected return of $0^{\frac{2}{3}}\%$.\(^{39}\)

The other two cases follow by analogy. The case of beta 1.5 and return of 14% creates a portfolio that is too dear and the arbitrageur will sell it and buy the cheap equivalent. The case of beta 0.5 and return of 6% indicates a portfolio that is too cheap and the arbitrageur will buy it and sell the dear equivalent.

The buying and selling of the arbitrageur connect the CAPM to supply and demand. The trading activity that the CAPM predicts pushes prices in the direction that validates the CAPM, since the CAPM predicts buying of assets that the CAPM deems cheap and the selling of ones that the CAPM deems overpriced. Effectively, the CAPM predicts trading for falsely priced assets, buying of the cheap and selling of the dear.

The empirical evidence mostly supports the CAPM with small discrepancies. The discrepancies could either be imperfections of the CAPM or imperfections of the statistical tests. The clearest support is the evidence that returns follow betas, even before the CAPM’s development. Researchers calculated the beta of every stock and segmented the market in a handful of portfolios, sorted by beta. The returns of the portfolios comply with their beta. The lowest beta portfolio had the lowest return and the portfolio with the greatest beta enjoyed the highest return. Moreover, as the CAPM predicts, changes of beta alter returns less than proportionately, so that a portfolio with beta half does not enjoy half the return of the

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\(^{39}\) For example, if the trader’s portfolio were $300,000, then the trader would place $200,000 in the beta 1.5 portfolio that has an expected return of 17% and $100,000 in the risk free asset for a return of 1%. The entire portfolio has a return of 11\% (instead of the 11\% of the actual market). If the market deviates by any percentage from its expected return, the expected deviation of the synthetic beta one portfolio would be the same. If, for example, the market were to deviate by 10%, the actual 1.5 beta portfolio would tend to deviate by 15% but the synthetic portfolio would only experience two thirds of that.

\(^{40}\) The synthetic portfolio has an expected return of 11\% and the trader earns that. The actual market portfolio has an expected return of 11\% and the trader sold it, therefore has given it up or owes it. The difference does not match the 2\% size of the error because the arbitrage did not occur at the mispriced beta but at the lower market beta. If the trader could borrow at the riskless rate, then the trader could synthesize the 1.5 beta by borrowing and investing 150\% in the market index.
beta one portfolio but a greater return. The main discrepancy is that instead of the risk free rate, the portfolios’ returns appear to hinge from a higher rate. However, since the essence of the CAPM would require that the risk-free return and the market return be after inflation and taxes, the existing discrepancies may well agree with an after-tax-and-inflation version of the CAPM.

C. Goods subject to Each Pricing Mechanism

The understanding of the pricing mechanisms allows us to express the principles that separate goods in two groups, those with prices that stem from the CAPM and those with prices that stem from supply and demand. Supply and demand applies to all goods. The CAPM applies to goods that perform mainly the financial function of carrying value through time.

Financial goods can exceed the valuation that the CAPM implies if they offer additional value. Examples of such values may be synergies for a buyer of control, or artistic value for collectors. Consider a corporation that is the target for an acquisition motivated by synergies. Before the acquisition, the CAPM processes the target’s future income to produce its price. The acquirer, however, finds additional value in the target because the synergies make the target’s business as well as acquirer’s business more productive. The acquirer offers a price greater than the CAPM indicates. Similarly, a collector of old railroad stocks offers for old certificates a price greater than the nearly zero value that the CAPM indicates.

These examples escape the pricing of the CAPM because the arbitrage to hold their price low fails. Sellers cannot synthesize them to the buyers’ satisfaction. The buyers seek more than a return for a given beta risk. The buyer of control seeks the operating synergies. The buyer of collectible stocks seeks the collector value.

Non-financial goods, particularly durable ones, also perform some financial functions. Jewelry and art, for example, have value as apparel or decoration but also for resale. Their financial value, however, does not stem from their contribution to economic production. Some non-financial goods may derive their financial value from their potential contribution to economic production. A house’s yard, for example, may derive part of its value from its potential use as farmland and the CAPM would underlie the valuation of farmland. The consumer’s value of the housing likely exceeds the
financial valuation. Unless the consumer valued the housing more, the land would tend to remain in its use as farmland.

Thus, the CAPM appears to drive the value of goods that serve only the function of storing value through time. Goods that serve additional functions escape from the CAPM and become subject to supply and demand. That the good performs only the function of holding value for its holder is necessary for the holder of the good to be willing to exchange it for a synthetic substitute with equal beta.

V. FROM THE SALE OF BUSINESS DOCTRINE TO GUSTAFSON

The legal definition of a security—a presumed intent to invest in a common enterprise—and its analysis as an investment with neither access to information nor control are consistent with the economic understanding of a security as a passive investment. However, the courts have followed a tortured path in the application of this analysis in transactions about controlling blocks of shares and in private transactions generally. The sale of business doctrine held control transactions not to be about securities. The Supreme Court in 1989 reversed the sale of business doctrine with Landreth and Ruefenacht.\(^{41}\) In a move of legal whiplash, six years later, in a transaction about control, the Court imposed relief from the remedies of securities law with Gustafson.\(^{42}\) That relief was broader than that of the sale of business doctrine and exempted all private transactions from the rescission remedy of securities law.

The prior parts walked through three analyses: (i) the legal definition of a security, which focuses on presumed intent to participate in a “common enterprise” without control (“from the effort of others”), (ii) its function, which relates it to lack of current access to information and lack of future control, and (iii) the economic analysis, which implies passivity. The harmony among them would be the happy conclusion, had the Supreme Court not rejected them by rejecting the sale of business doctrine and then reinstated them but implicitly and partly, in the same context of transactions about controlling blocks of shares with Gustafson.


According to the sale of business doctrine, the sale of the shares forming the controlling block of a business was not the sale of a security despite the form of a sale of shares. The Circuits that adopted it relied on the distinction of *Forman* from *Howey*.43

In essence, the sale of business doctrine promotes substance over form. The form of a sale of stock is as misleading as it was in *Forman*. The buyers obtain control. Therefore, they do not fulfill the *Howey* definition since they neither invest in a common enterprise nor seek profit from the effort of others. Obtaining control is also antithetical with the function of the *Howey* test, since a buyer of control tends to have the negotiating power to examine the entire enterprise and will have the right to control. Buying control also fails the economic understanding of a security as a passive investment because the acquirer can change the administration of the target and can extract synergies or perquisites.

Despite that the sale of business doctrine promotes substance over form and adheres to the analysis of *Howey* and *Forman*, the Supreme Court repudiated it in two opinions issued on the same day.44 The *Landreth/Ruefenacht* pair of opinions rejected applicability of *Forman* and the sale of business doctrine rather summarily. Because stock in sales of control has the usual features of stock—mostly by including votes and dividends—*Forman* does not apply.45 The sale of business doctrine was rejected because it had the capacity to lead to vagueness and inconsistencies. The vagueness is the result of the lack of a specific percentage that constitutes sale of control. The inconsistencies come from the fact that a single transaction may disperse or create control.

43. See, e.g., *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981), cert. denied, 451 U.S. 1017, 101 S.Ct. 3006, 69 L.Ed.2d 389 (1981) (“Not all transactions which involve ‘stock’ are necessarily covered by the securities laws. Rather, the test for coverage, in general, is whether the purchaser is placing money in the hands of another who will control the funds and the business decisions. If, however, the purchaser is assuming control of the critical decisions of the corporation, then the transaction is not considered to involve securities.”). *See also Sutter v. Groen*, 687 F.2d 197, 202 (7th Cir.1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465 (7th Cir.1981); *Frederiksen v. Poloway*, 637 F.2d 1147, 1151-52 (7th Cir.1981); *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir.1983); *Chandler v. Kew, Inc.*, 691 F.2d 443, 444 (10th Cir.1977); *King v. Winkler*, 673 F.2d 342, 345 (11th Cir.1982).


45. See above, text accompanying notes 18-20 (the *Forman* stock did not grant its holders voting power proportional to the number of shares held because voting in the association was by apartment; the stock would not bring any dividends, rather the leasing of common areas benefitted financially the occupants by reducing the common expenses).
The Supreme Court’s choice to abolish the sale of business doctrine with the Landreth and Ruefenacht opinions underlines the Court’s concern with these issues. The two sets of facts illustrate the possible inconsistencies. Landreth regarded the acquisition of 100% of the stock of a lumber mill by a syndicate of passive investors. Ruefenacht featured a buyer of 50% who expected to be involved in the running of the business. Not only did the “from the effort of others” element of the definition seem to apply in the transaction for the 100% but not in that for the 50% but also control was unclear in both. The sellers had 100% control before both transactions. In Landreth, the purchase dispersed control among the several buyers. In Ruefenacht, the purchase split control between two 50% shareholders, leaving neither one with absolute control.

Regardless of the wisdom behind the 1989 rejection of the sale of business doctrine, the Supreme Court reinstated it in 1995 with Gustafson. The reinstatement, however, is implicit, too broad, but also too narrow. On its face, Gustafson merely held that “prospectus” means a disclosure document used in a public offering and, since private offerings do not use one, buyers in private offerings do not have the rescission remedy of § 12 against buyers who make a misleading statement “through a prospectus.” Subpart A introduces the registration process, which is necessary to understand the potential magnitude of Gustafson. Subpart B underscores the revolutionary approach of Gustafson but subpart C recognizes that the dangers that Gustafson could have caused did not materialize.

A. Registration Process Primer

The predicate for understanding Gustafson’s changes is an understanding of the Securities Act of 1933 (the “’33 Act”). The ’33 Act establishes the process of registering with the Securities and Exchange Commission (the “SEC”) that any corporation issuing securities to the public must follow, the registration process.

The heart of the ’33 Act is section 5, which determines the registration process. Section 5 turns on three events: filing, effectiveness, and free writing. Filing is the date that the registration state-

46. Landreth, 471 U.S. at 683-84, 695-96.
47. Ruefenacht, 471 U.S. at 702-03.
49. Gustafson, 513 U.S. at 580-82.
ent is filed with the SEC. Effectiveness is the date when the SEC declares it effective. Free writing for each investor starts the moment that a complete and effective registration statement is transmitted to that investor. Free writing is the holy grail of the registration process, after which the issuer can even send glossy puffery.

The two most restrictive prohibitions of section 5 are against offers and prospectuses. Their restrictiveness flows from the breadth of the corresponding definitions in § 2. Offer is defined as “every attempt or offer to dispose of, or solicitation of an offer to buy.”51 To appreciate the breadth of this definition, contrast it with contract law’s definition of offer as a proposition that can be accepted.52 Merely presenting an item in appealing circumstances is an offer under securities law whereas under contract law it is, at most, a solicitation of an offer. Prospectus is defined as “any … communication … which offers any security for sale or confirms the sale of any security.”53 To appreciate the breadth of this definition, contrast it with the plain understanding of prospectus as an explanatory manual or guide. Letters soliciting offers and sales contracts would be prospectuses under securities law.

Section 5 prohibits offers, sales, the transmission of prospectuses, and the delivery of securities. By deploying these prohibitions at different times, section 5 shapes the registration process. Through the prohibition of § 5(c), section 5 prohibits offers before filing.54 Through the prohibition of § 5(a)(1), section 5 prohibits sales before effectiveness.55 Through the prohibition of § 5(b)(1), section 5 prohibits the transmission of most prospectuses before free writing.56 Through the prohibition of § 5(b)(2), section 5 prohibits the delivery of securities before free writing.57

52. FARNSWORTH ON CONTRACTS § 3.10 (2011)
54. § 5(c) of the ‘33 Act, 15 U.S.C. § 77e(c) (2006) ("It shall be unlawful … to offer … unless a registration statement has been filed").
55. § 5(a)(1) of the ‘33 Act, 15 U.S.C. § 77e(a)(1) (2006) ("Unless a registration statement is in effect, it shall be unlawful … to sell").
56. § 5(b)(1) of the ‘33 Act, 15 U.S.C. § 77e(b)(1) (2006) ("It shall be unlawful … to transmit any prospectus … unless …", as it interacts with the exception of § 2(a)(10)(b) to the definition of a prospectus: “a … communication …after the effective date … shall not be deemed a prospectus if a [complete] prospectus …was sent or given").
The definitions of § 2 interact with § 5 by design. For example, despite the prohibition against offers, § 2 creates an exception for offers in the context of negotiations between underwriters and the issuer so as to enable the creation of the underwriting syndicate, the group of brokerage houses that will sell the new security to their customers.\(^{58}\)

The definition of prospectuses in § 2(a)(10) is especially interactive with § 5. Despite that § 5 prohibits the transmission of prospectuses (any selling communication per § 2(a)(10)), section 2(a)(10)(b) defines some communications not to be prospectuses, so very limited advertising can occur.\(^{59}\) The definition of the prospectus by § 2(a)(10) also creates free writing, the goal of the registration process. Section 2(a)(10)(a) creates free writing by an exception that, after the transmission of a fully compliant and effective registration statement, no communication is a prospectus.\(^{60}\) This contrasts with Gustafson’s understanding of a prospectus as a document used in public offerings.\(^{61}\)

The final step in understanding the registration process is § 10. Unlike the definitional role it takes in Gustafson, § 10(a) of the ’33 Act contains the information required in the registration statement (by reference to schedules appended to the Act).\(^{62}\) The

\(^{58}\) § 2(a)(3) of the ’33 Act, 15 U.S.C. § 77b(a)(3) (2006) ("The terms defined in this paragraph ... shall not include preliminary negotiations or agreements between an issuer ... and any underwriter or among underwriters ...")

\(^{59}\) § 2(a)(10)(b) of the ’33 Act, 15 U.S.C. § 77b(a)(10)(b) (2006) ("[E]xcept that ... (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.")

\(^{60}\) § 2(a)(10)(a) of the ’33 Act, 15 U.S.C. § 77b(a)(10)(1) (2006) ("[E]xcept that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person to whom the communication was made").

\(^{61}\) Gustafson, 513 U.S. at 574 ("The relevant phrase in the definitional part of the statute must be read in its entirety, a reading which yields the interpretation that the term “prospectus” refers to a document soliciting the public to acquire securities. We find that definition controlling.")

\(^{62}\) § 10 of the ’33 Act, 15 U.S.C. § 77j (2006) ("(a) Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e)—(1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32),
registration process is enforced mostly through §§ 11 and 12. Section 11 imposes liability for misstatements in the registration statement upon the issuer, the underwriters, experts, and others.63 Section 12 gives buyers the rescission remedy against sellers who made a misleading statement or omission through “a prospectus or oral communication.”64 This rescission of a private sale under § 12 is what the *Gustafson* plaintiffs sought and did not get, what the sale of business doctrine would have denied them, but what *Landreth* and *Ruefenacht* did grant to their plaintiffs by rejecting the sale of business doctrine.

Two illustrations, a public offering and a private one, show how, before *Gustafson*, § 10 was consistently not used as a definitional section in illegal offerings of securities. Observe, first,

63. § 11 of the '33 Act, 15 U.S.C. § 77k (2006) (“In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—(1) every person who signed the registration statement; (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; (5) every underwriter with respect to such security.”)

64. § 12 of the '33 Act, 15 U.S.C. § 77l (2006) (”Any person who—(1) offers or sells a security in violation of section 5, or (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon”).
how a public offering with no filing violates every prohibition of
section 5. Second, follow buyers in a private transaction, as was that of
Gustafson. Before Gustafson, buyers in a private offering containing a
material misrepresentation or omission would obtain the rescission
remedy of section 12, even if the transaction was oral.

An issuer who, without filing, sells securities to the public violates
section 5 in every way. When the issuer makes its offer, the
issuer violates the prohibition of § 5(c) against offers before filing.
Even if the issuer files a registration statement, when the issuer
sends any materials or draft contracts to potential buyers, the issuer
violates the prohibition of § 5(b)(1) against the transmission of
prospectuses (defined in § 2(a)(10) to include “any … communica-
tion … which offers any security for sale …”).65 When the issuer
executes the sale contract, the issuer violates the prohibition of
§ 5(a)(1) against sales before effectiveness. If the issuer delivers the
securities, the issuer violates the prohibition of § 5(a)(2) against
deliveries. Section 10 never defines anything, whereas it may after
Gustafson.

An issuer who makes a private sale before Gustafson enters
into an exempt transaction. According to section 4, “[t]he
provisions of section 5 shall not apply to … (2) transactions … not
involving any public offering.”66 Since the items sold are securities,
however, section 12 still applies and grants the buyer rescission
against “(a) [a]ny person who … (2) offers or sells a security … by
means of a prospectus or oral communication … which … omits to
state a material fact.” Even if the private transaction is not in writing
(to avoid the prospectus-based violation of § 12) the oral
communication would be enough for § 12 to produce its rescission
remedy. Section 12 operates on sales though a misleading
“prospectus or oral communication.” Again, § 10 never defines
anything, whereas it does after Gustafson.

According to the above pre-Gustafson reading of the ’33 Act, all private sales of securities would be subject to the rescission
remedy of § 12. However, the sale of business doctrine would have

65. The sending of materials and draft contracts also violates the prohibition against offers.
That prohibition, however, ends with the filing, when the prohibition on the transmission of
prospectuses begins. Thus, technically, if the issuer does not file a registration statement at all,
then the issuer only violates § 5(c) (prohibiting offers) and § 5(a) (prohibiting sales and
deliveries before effectiveness). As the registration process is sufficiently complex, the text
does not focus on the initiation of the prohibition against prospectuses at the time of the filing.
made § 12 not apply to transactions about control. Before *Gustafson*, § 12 would apply to all other private transactions (also known as private placements).

**B. Gustafson as Earthquake**

The *Gustafson* majority departed from the above conventional reading of the securities laws in four ways. (1) The *Gustafson* majority read section 12 to apply only to misrepresentations in a prospectus.\(^{67}\) Pre-*Gustafson*, section 12(b) had applied to sales though “a prospectus or oral communication.”\(^{68}\) (2) The *Gustafson* Court construed section 10 as attempting to define the prospectus.\(^{69}\) Pre-*Gustafson*, section 2(a)(10) defined the prospectus.\(^{70}\) (3) As the *Gustafson* majority found in § 10 only references to the registration statement used in public offerings but no definition, the majority took the license to interpret prospectus as a document used in a public offering.\(^{71}\) Pre-*Gustafson*, section 2(a)(10) defined prospectus as “any … communication … which offers any security for sale …”.\(^{72}\) (4) The court concluded that the buyer did not have the rescission remedy because no prospectus had been used.\(^{73}\) Pre-*Gustafson*, the sale contract would have been a prospectus with material omissions that would have triggered rescission under section 12.\(^{74}\)

The unanimous condemnation of *Gustafson* by the academy\(^ {75}\) and the bar\(^ {76}\) is unsurprising. The reasoning of *Gustafson* had

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67. *See Gustafson*, 513 U.S. at 578 (“The intent of Congress and the design of the statute require that § 12(2) liability be limited to public offerings.”).

68. *See text accompanying notes 64-66, above.*

69. *See Gustafson*, 513 U.S. at 574 (“To be sure, [section 10] defines a prospectus as, *inter alia*, a ‘communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.’”); *Id.* at 589 (Thomas, J., dissenting) (“The majority transforms § 10 into the tail that wags the 1933 Act dog.”); *Id.* at 597 (Ginsburg, J., dissenting) (“The Court then proceeds backward; it reads into the literally and logically prior definition section, § 2(10), the meaning ‘prospectus’ has in § 10.”).

70. *See text accompanying notes 58-61, above.*

71. *See Gustafson*, 513 U.S. at 574 (“[T]he term ‘prospectus’ refers to a document soliciting the public to acquire securities.”).

72. *See text accompanying notes 51-53, above.*

73. *See Gustafson*, 513 U.S. at 584 (“In sum, the word ‘prospectus’ is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder. The contract of sale, and its recitations, were not held out to the public and were not a prospectus as the term is used in the 1933 Act. The judgment of the Court of Appeals is reversed…”).

74. *See text accompanying notes 64-66, above.*

75. *See, e.g., Stephen M. Bainbridge, Securities Act Section 12(2) After the Gustafson Debacle, 50 Bus. Law. 1230 (1995); Janet E. Kerr, Ralston Redux: Determining which Section
the capacity to upend the application of securities laws. Consider sales of securities without any filing. Under Gustafson’s reasoning they could have been held to violate neither § 5 nor § 12 due to the absence of a prospectus. Consider private sales by oral communication. Although they should be subject to registration as public offers, under Gustafson’s reasoning, sellers could avoid the rescission remedy, again due to the absence of a prospectus. Even more perniciously, Gustafson’s implicit disregard of the statutory language and structure could have become a license to make arbitrary conclusions about securities law. Gustafson was an earthquake that could leave securities regulation in shambles.

C. No Rubble After Gustafson

Although an expansive reception of Gustafson could have spelled the demise of the ’33 Act, courts did not embrace its expansiveness. Rather, courts restricted Gustafson to apply only to private transactions. Public offerings, written or oral, are still subject to section 5 and the registration process. For public offerings, selling communications transmitted before free writing can violate § 5 as illegal prospectuses because, in public offerings prospectuses still are defined by § 2(a)(10), despite Gustafson. Private transactions, however, are subject to Gustafson’s understanding of prospectus as a public offering document, which contradicts and precludes the definition of prospectus according to § 2(a)(10) as “any … communication … which offers … any security.”

The following Subparts examine the consequences of Gustafson with the benefit of hindsight. Transactional practice did not change. Therefore, the only change that Gustafson brought is the elimination of rescission in private sales. Despite the negative reception of Gustafson, we cannot attribute to Gustafson broader consequences, such as the subprime lending crisis. Gustafson’s repeal of the rescission remedy is appropriate in view of the rejection of the sale of business doctrine by Landreth and Ruefenacht.

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1. **PRIVATE PLACEMENT MEMORANDA CONTINUE, RESCISSION ENDS**

The continued use of private placement memoranda in private sales is almost paradoxical. The elimination of rescission by *Gustafson* was not trivial. Nevertheless, the use of these memoranda continued. The cause of their continued use is not obvious. Hopefully, the force of habit is not so strong as to perpetuate their use, particularly since they are voluminous documents and costly to produce. Presumably, then, the leading cause for the continued use of private placement memoranda is the rest of securities laws, mostly the SEC rules about private sales (mostly Regulation D, rules 501 et seq.) and securities fraud liability. Thus, the *Gustafson* tempest is restricted to the teapot of § 12.

2. **CANNOT ATTRIBUTE THE SUBPRIME MORTGAGE CRISIS TO GUSTAFSON**

One is tempted to think of the subprime mortgage crisis as a consequence of *Gustafson*’s relaxation. The reasoning begins from the realization that the selling of collateralized mortgage obligations occurred through private sales, not public sales of securities. The elimination of the rescission remedy by *Gustafson* was public knowledge. Therefore, private sales were less deterred than they were before *Gustafson*.

Whereas this reasoning is correct, voluminous disclosure documents (usually called “Private Placement Memoranda”) continue to be produced after *Gustafson* for private sales, generally, and for sales of collateralized mortgage obligations. Private Placement Memoranda essentially contain most of the disclosures required in the registration statement. In particular, they include an extensive coverage of potential sources of risk. Whereas *Gustafson* did reduce the need for substantive disclosure in private sales, a significant disclosure practice remains. The cause of the continued disclosure in private sales is irrelevant. Disclosure may still occur due to the incentives of the remaining securities law remedies, state laws or habit. The point is that *Gustafson* did not end the practice of intense disclosure in private transactions.

Therefore, even if *Gustafson* had retained the rescission remedy, buyers of collateralized mortgage obligations would not have received it often. The adverse movement of home values would be an obvious disclosure to make. The mere disclosure of the possibi-

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77. 17 C.F.R. §§ 230.500 et seq.
lity of drops of home prices would prevent buyers from claiming that they bought the collateralized mortgage obligations through a materially misleading communication. Thus, the buyers may well not have obtained the rescission remedy under § 12.

VI. GUSTAFSON WORKS!

Gustafson, despite twelve years, one financial crisis, and heaps of unanimous condemnation, keeps looking better. To appreciate the resulting regime, identify the four distinct stages that produced it. Before Forman the sale of business doctrine had not arisen. Rescission applied to all sales of securities and sales of control were securities. After Forman many circuits adopted the sale of business doctrine, therefore, sales of control were not about securities and did not trigger rescission. Then, Landreth and Ruefenacht repealed the sale of business doctrine and reproduced the pre-Forman regime. Finally, Gustafson repealed rescission in private sales of securities. Due to the incompatibility of rescission with sales of control and the error of its rejection by Landreth and Ruefenacht, the pre-Forman period and the period between Landreth and Gustafson are not relevant and confuse the analysis. Two regimes matter, one with the sale of business doctrine but without Gustafson and one without the sale of business doctrine but with Gustafson.

Moreover, the “error” of Gustafson is intertwined with Landreth and Ruefenacht. Gustafson involved a rescission claim in a private purchase of control that would not have been considered to be about a security if the sale of business doctrine had been upheld. If Landreth and Ruefenacht had upheld the sale of business doctrine, then the dispute that led to Gustafson would not have arisen.

Therefore, rather than react viscerally to Gustafson’s disregard of the text of the ’33 Act, the salient question is whether securities law would be better if Landreth and Ruefenacht had upheld the sale of business doctrine but Gustafson had not repealed rescission in private sales rather than have our current regime. Thus, the counterfactual regime keeps the sale of business doctrine and grants rescission for private sales. Thus, under the counterfactual regime of the sale of business doctrine without Gustafson, although rescission is available for private sales, sales of control are not
securities and do not trigger securities remedies. By contrast, under the existing regime of *Gustafson*, private sales of control and private sales are treated alike as securities transactions but without the rescission remedy.

Revisit the analysis of securities transactions in Parts II, III, and IV, that justified the departure from buyer beware and the transition to seller disclose. The desirable regime depends on who has information and control. Buyers of securities who do not get control cannot inspect the entire enterprise and will not control it, justifying the securities regime of seller disclose. However, private sales of control contradict the economic setting of securities transactions. The buyer has the bargaining power and the economic incentives to inspect the entire enterprise and the buyer will control the enterprise. Because buyers of control can inspect and will control, the remedies and disclosure obligations of securities law are not justified. Sales of control should give rise to neither disclosure obligations nor rescission.

While both the counterfactual regime of the sale of business doctrine and the existing regime of *Gustafson* are alike in not granting rescission for private control transactions, we saw that the existing regime is slightly more exacting. The existing regime treats private sales of control as securities, therefore granting securities fraud protection, whereas the sale of business doctrine would not treat them as securities and would leave them to the protection of common law deceit. The following paragraphs show that the existing *Gustafson* regime is justified because its repeal of rescission is correct and because securities fraud protection in private sales of control is not excessive.

A. Rescission Repeal Correct

In private sales that do not involve control, buyers may well not have the bargaining power and economic incentives to examine the entire enterprise. Moreover, the buyers will not control the

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78. See text accompanying notes 2-40, above.
79. See text accompanying notes 23-26, above.
administration of the enterprise. Although this suggests that buyers in private sales deserve the protection of securities law, a caveat is necessary.

_Rawlston Purina_\(^81\) and Regulation D\(^82\) ensure that buyers in private sales have the sophistication and the information to “fend for themselves.”\(^83\) Private sale participants must be “accredited investors,” defined as sophisticated and wealthy institutions or individuals.\(^84\) The substance of the disclosure in private sales largely matches that of the disclosure in public offerings.\(^85\)

_Rawlston Purina_ rendered obsolete the rescission remedy that _Gustafson_ eventually eliminated. The rescission remedy of § 12 was drafted at the initial passage of the '33 Act, before the substantive protection afforded by _Rawlston Purina_ and Regulation D.\(^86\) During the passage of the '33 Act, the drafters could not anticipate how the interpretation of the exemption for private offerings would be interpreted. If the private offering exemption turned on the privacy of the offer, then buyers would deserve the rescission remedy and § 12 should have included rescission, as it did. However, _Rawlston Purina_ and Regulation D ensure that the private offering exemption is only available if the offerees “can fend for themselves” by sophistication and information. The result of _Rawlston Purina_ is a level of protection in private sales that could not have been anticipated by the drafters of the '33 Act.

Suppose the drafters had defined exempt offerings as those made to investors with the sophistication and information to fend for themselves, rather than exempting offerings that “not involving any public offering.”\(^87\) The capacity for self protection makes rescission excessive. _Rawlston Purina_ rendered rescission obsolete and _Gustafson_ was correct to override the letter of the ’33 Act and abolish rescission.

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\(^83\) _Rawlston_, 346 U.S. at 124 (“An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’ ”)

\(^84\) See Rule 501, 17 C.F.R. § 230.501 (2012) (defining accredited investors in section (a) to include under (1) any bank, under (7) “Any trust, with total assets in excess of $5,000,000,” under (5) “Any natural person whose individual net worth … exceeds $1,000,000”, and under (6) “Any natural person who had an individual income in excess of $200,000”).

\(^85\) See Rule 502, 17 C.F.R. § 203.502 (specifying under (b)(2)(B) that the issuer must furnish, e.g., in offerings greater than $7,500,000 “[t]he financial statement as would be required in a registration statement filed under the ‘33 Act’”).

\(^86\) See text accompanying notes 81-85, above.

Not only is the protection of *Rawlston Purina* and Regulation D superior to what the drafters of the ’33 Act could have expected for private sales, it is more effective protection than that provided by § 5 itself in public offerings. Section 5 allows the delivery of securities and puffery contemporaneously with the delivery of the prospectus and allows sales before even the delivery of the prospectus. The transaction practice that *Rawlston Purina* and Regulation D have produced, however, results in delivery of the private placement memorandum (with information equivalent to that of the prospectus) before the sale. Thus, buyers in private sales have the fuller protection of actually having the chance to digest the information whereas § 5 allows sales without information.

B. *Fraud Protection not Excessive*

The second difference of the current regime from that of one without *Gustafson* but with the sale of business doctrine is that private sales of control are securities and, therefore, receive securities fraud protection. Securities fraud protection for private sales of control is not excessive. Unlike rescission, fraud protection does not place the risk of the transaction on the seller. Fraud protection merely ensures that the buyer obtains correct information from the seller. Consider how a misleading omission leads to different results under (only) fraud protection than under rescission. Rescission turns full disclosure into risk for the seller. The buyer, by pointing to the seller’s omission to warn about a risk that materialized, can rescind for surprises that the buyer would not have considered material at the time of the transaction. Under fraud protection, the buyer must show actual reliance on the misrepresentation or omission at the time of the transaction. To recover for an omission, therefore, the buyer must have revealed to the seller the reasons driving the buyer’s transaction.

To illustrate, consider a variation on the acquisition of Marvel by Disney. Suppose that Marvel characters had a structural incompatibility with three dimensional films. Suppose that Disney acquired Marvel in a private sale, that Disney intended to produce

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88. See text accompanying notes 65-66, above.
3D movies with the characters, that the seller did not know that, that the seller knew that the Marvel characters were incompatible with 3D filmmaking, and omitted to disclose it. Compare the treatment of this omission under fraud and under rescission. If Disney did not mention to the seller its intention of making 3D movies with the Marvel characters, Disney cannot show reliance on the seller’s silence about their incompatibility with 3D. If Disney has the right to rescind the transaction, however, then proof of reliance is unnecessary. Disney would simply exercise its right to rescind.

Thus, fraud protection lets the transaction stand whereas rescission places its risk on the seller. If Marvel were to conduct a public offering, however, buyers could rescind if it did not disclose its characters’ incompatibility with 3D. Thus, public offerings continue to operate in a legal environment of seller disclose, with a caveat about tracing.90

VII. CONCLUSION

In sum, private sales of control (and private sales, generally) occur in an environment of buyer beware, rather than under one of seller disclose. As we had seen, buyers of control extract non-financial value from the target, such as perks and synergies. The seller cannot know what such values the buyer appreciates and, therefore, cannot meaningfully bear an obligation to disclose about them. Thus, the harmony of the law with the reality of access to information and future control is consistent despite the rejection of the sale of business doctrine.

The search for the essence of the definition of a security is constructive but the textual analysis of Gustafson seems to frustrate it. Whereas Howey and Forman set the interpretation of securities laws on a solid course of substance over form, substance has suffered in Landreth, Ruefenacht, and Gustafson. The sale of business doctrine placed substance over form but the Supreme Court struck it, only to reinstate it implicitly and countertextually with Gustafson. While Gustafson reinstates the consequences of the sale of business doctrine, it does not adhere to the substance-over-form tradition that is the strength of the interpretation of securities laws. Nevertheless, in combination with Rawlston Purina, the

90. See Hillary A. Sale, Disappearing Without A Trace: Sections 11 and 12(2) of the ’33 Act, 75 WASH. L. REV. 429 (2000).
resulting regulation of private sales of securities is surprisingly appealing from a normative perspective and superior to what the '33 Act drafters could have envisioned for private sales.

APPENDIX A: PRICES OF STOCK AND S&P500 INDEX

Table A1 presents the weekly prices of Activision Blizzard, Inc. (stock symbol ATVI) and the S&P500 stock index for the thirty weeks ending October 28th 2011. For comparison, the table also follows Prudential Financial, Inc. (stock symbol PRU).

Table A1: Weekly Prices and their Changes

<table>
<thead>
<tr>
<th>Week ending</th>
<th>S&amp;P500</th>
<th>ATVI</th>
<th>PRU</th>
<th>Changes of Prices</th>
<th>S&amp;P500</th>
<th>ATVI</th>
<th>PRU</th>
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<td>28-Oct-11</td>
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<td>53.23</td>
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<td>50.92</td>
<td>5.98% 3.19% 10.65%</td>
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<td>0.31% 1.94% -0.60%</td>
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<tr>
<td>01-Jul-11</td>
<td>1339.67</td>
<td>11.84</td>
<td>64.77</td>
<td>5.61% 4.87% 8.47%</td>
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<tr>
<td>24-Jun-11</td>
<td>1268.45</td>
<td>11.29</td>
<td>59.71</td>
<td>-0.24% 3.86% 0.88%</td>
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<td>17-Jun-11</td>
<td>1271.50</td>
<td>10.87</td>
<td>59.19</td>
<td>0.04% -5.15% 0.25%</td>
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<td>10-Jun-11</td>
<td>1270.98</td>
<td>11.46</td>
<td>59.04</td>
<td>-2.24% -3.21% -3.62%</td>
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<td>03-Jun-11</td>
<td>1300.16</td>
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<td>-2.32% 3.41% 3.02%</td>
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<td>27-May-11</td>
<td>1331.10</td>
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<td>63.17</td>
<td>-0.16% -1.29% -0.69%</td>
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<td>20-May-11</td>
<td>1333.27</td>
<td>11.60</td>
<td>63.61</td>
<td>-0.34% 0.78% 0.76%</td>
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<tr>
<td>13-May-11</td>
<td>1337.77</td>
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<td>63.13</td>
<td>-0.18% 0.61% -0.89%</td>
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<td>06-May-11</td>
<td>1340.20</td>
<td>11.44</td>
<td>63.70</td>
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<td>29-Apr-11</td>
<td>1363.61</td>
<td>11.38</td>
<td>63.42</td>
<td>1.96% 0.53% 2.74%</td>
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<td>21-Apr-11</td>
<td>1337.38</td>
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<td>61.73</td>
<td>1.34% 0.80% 1.20%</td>
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<td>15-Apr-11</td>
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<td>11.23</td>
<td>61.00</td>
<td>-0.64% 0.81% -2.06%</td>
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<td>08-Apr-11</td>
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<td>11.14</td>
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<td>Betas: 0.6229 1.5265</td>
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91. Most financial news websites offer historical prices. These prices come from Google finance (www.google.com/finance, last visited June 22, 2012). Financial sites provide four prices to describe each period's activity, the “opening” price of the first transaction, the high, low and the “closing” price of the last transaction. Table 1 uses the weekly closing prices.