NOTE

WITH WHOM IS YOUR ISSUE?: USE OF INVESTOR SOPHISTICATION IN DEFINING THE SCOPE OF SELLER LIABILITY UNDER § 12(A)(2) OF THE SECURITIES ACT OF 1933

Zachary Becker*

The rise of social media in the last two decades has given retail investors unprecedented information about and access to financial markets. But the introduction of new marketing strategies for financial products has also introduced new challenges for financial regulators. Regulatory agencies and judicial bodies alike are tasked with conforming the investor protection and market efficiency statutes of the 1930s to contemporary problems. Responses to the new paradigm of social media have diverged, though. One such divergence is the standard applied for Section 12(a)(2) liability under the Securities Act of 1933. Some circuit courts rely on traditional precedents that require direct solicitation of the investor as set forth in Capri v. Murphy *and* Craftmatic Securities Litigation v. Kraftsow. *Meanwhile others have responded that mass communications like social media can give rise to Section 12(a)(2) liability. Most recently, the Ninth Circuit adopted this approach in* Pino v. Cardone Capital LLC. *This circuit split not only increases uncertainty amongst issuers of securities about the scope of potential liability. It also encourages forum shopping by plaintiffs seeking courts with broader and more favorable liability*

* J.D. Candidate 2025, Columbia Law School; B.A. 2022, Columbia University. My sincere gratitude to Professor Joshua Mitts and the staff of the Columbia Business Law Review for their thoughtful comments and valuable guidance. An additional note of appreciation to my family for their support and encouragement through my educational career.

schemes. This Note proposes a solution to the circuit split in the form of an investor sophistication standard.

I. INTRODUCTION

Financial regulators, including the Securities and Exchange Commission (SEC), are responding with increasing frequency to challenges presented by the proliferation of social media platforms that existing regulatory regimes do not address.[1] Federal courts continue to grapple with the scope of

[1] Richard Summerfield, *The Intersection of Securities Regulation and Social Media*, FINANCIER WORLDWIDE, Sept. 2015, https://www.financierworldwide.com/the-intersection-of-securities-regulation-and-social-media [https://perma.cc/L2TQ-ZGBT].

seller liability under the Securities Act of 1933 for misrepresentations and omissions circulated in advertisements on mass communication platforms like social media. Circuits have split in cabining or expanding seller liability to respectively preclude or reach the mass communications facilitated by social media.[2] The venue in which injured investors seek relief is now outcome determinative for some claims. This circuit split increases the risk of forum shopping and contributes to uncertainty amongst issuers of financial instruments when appraising their potential liabilities for advertisements and disclosures.

This Note proposes an investor sophistication standard that courts should adopt to resolve the circuit split and effectively balance protections for retail investors with the administrability and predictability of seller liability. Part II introduces the Securities Act of 1933 as a route to compensatory relief and prophylactic disincentive for market abuse intended to secure investor protection and market efficiency. This sketch of the legal landscape will include how circuit courts have traditionally applied the '33 Securities Act to offerors or sellers of securities marketing their instruments through mass communication media, and how some circuit courts have departed from the traditional approach in favor of a more expansive standard for seller liability that captures solicitors who advertise security offerings on social media platforms. Part III will then present the theoretical framework and judicial history of sophistication standards to demonstrate their suitability for securities regulation. Part III will present why a generalizable standard should be abandoned in favor of a more nuanced, tailored analysis dependent not just on the role of the participant but on the role of the purchaser as well. Finally, Part IV will present this Note's proposal for a seller sophistication standard. Examples

[2] Charlene S. Shimada et al., *Ninth Circuit Holds that Social Media Posts Can Give Rise to Securities Act Liability*, MORGAN LEWIS (Dec. 30, 2022), https://www.morganlewis.com/pubs/2022/12/ninth-circuit-holds-that-social-media-posts-can-give-rise-to-securities-act-liability [https://perma.cc/M7GF-FX3R] (discussing the Ninth Circuit and the Eleventh Circuit's departure from the Second Circuit and Third Circuit's narrower interpretations of the 1933 Securities Act).

of how courts have previously used party sophistication will inform the discussion of ways in which such a standard should be curated for the purposes of financial regulation.

II. THE SECURITIES ACT OF 1933 AS A VEHICLE FOR INVESTOR PROTECTION

A. Development of the Statutory Regime for Securities Regulation

Congress enacted the Securities Act of 1933 in response to the preceding decade's market abuse and fraud with the intent to "ensure investors are informed and protected."[3] Advancing the twin goals of information and protection, Section 12(a)(2) of the Securities Act makes liable any person "who offers or sells a security," through a prospectus or oral communication that contains a material misstatement or omission, to "the person purchasing such security from him."[4] Whilst the statute grants a purchaser a claim for relief to compensate injuries suffered from a securities transaction predicated on misrepresentations or omissions, it also serves to incentivize seller behavior.[5] For issuers offering or selling securities, the risk of liability for misstatements or omissions encourages accurate and truthful representations in the course of the transaction.[6]

[3] Rachel Epstein, *"Smart Securities" and the Future of Securities Regulation*, 90-Feb. N.Y. ST. BAR ASS'N J. 34, 35 (2018). *But see* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 713–14 (suggesting that "[s]ecurities regulation is not a consumer protection law" but a regime to attain market efficiency). The benefits of market efficiency, namely accurate pricing and liquidity, confer benefits to investors in the form of greater confidence and access to transactions.

[4] 15 U.S.C. § 77l(a).

[5] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933) (footnotes omitted) ("The civil liabilities imposed by the Act are not only compensatory in nature but also *in terrorem*.").

[6] *Id.* ("They [the civil liabilities] have been set high to guarantee that the risk of their invocation will be effective in assuring that the 'truth about securities' will be told.").

The burden of investor protection, and thus the scope of seller liability, extends beyond the owner of the security prior to the transaction. The Supreme Court rejected a narrow definition when it held that the scope of seller liability under Section 12(1)[7] of the Securities Act is not limited to "persons who pass title."[8] Section 12(a)(2) creates a private right of action against an offeror, in addition to a seller, upon injury suffered by a purchaser after the sale of a security.[9] Congress included offerors within the statute's scope to more explicitly capture people who solicit investors without directly owning the securities, like brokers, even though such solicitors were initially included in the original definition of a seller under Section 2(3).[10] The Court reasons that because "brokers and other solicitors are well positioned to control the flow of information to a potential purchaser" and are those who "most often disseminate material information to investors," solicitation is the stage of a securities sale at which investors are most at risk of being induced to purchase securities without complete information and are most likely to suffer injuries.[11] Extending liability to solicitors, therefore, facilitates the *in terorrem* incentives for investor protection that the Securities Act was designed to advance.[12]

Not all participants in a transaction, though, are subject to seller liability, even if they engaged in the solicitation of investors who ultimately purchase the securities being marketed. Liability excludes disinterested, gratuitous suggestions and extends only to people who successfully solicit

[7] Many courts and commentators have noted that the seller liability analysis for Section 12(1) is equivalent to the analysis for defendant classes under Section 12(2), the precursor to the modern Section 12(a)(2). The *Pinter* Court, however, did not extend its holding to the Section 12(2) despite the same governing language of "offers or sells," so the generality of the *Pinter* analysis only remains informative until the Court revisits the matter. *See* Joseph E. Reece, *Would Someone Please Tell Me the Definition of the Term 'Seller': The Confusion Surrounding Section 12(2) of the Securities Act of 1933*, 14 DEL. J. CORP. L. 35 (1989).

[8] Pinter v. Dahl, 486 U.S. 622, 643 (1988).

[9] *See* 15 U.S.C. § 77l(a)(2).

[10] *See Pinter*, 486 U.S. at 645.

[11] *Id.* at 646–47.

[12] *See id.* at 647.

the purchase of a security when the solicitor is motivated by one's own financial interests or the financial interests of the security owner.[13]

B. Traditional Application of § 12(a)(2) Seller Liability to Mass Communications

The contours of Section 12(a)(2) liability for financially interested offerors who solicit the purchase of securities were further defined by two circuit court opinions just a year apart. In *Capri v. Murphy*, the Second Circuit held that a plaintiff must demonstrate that an issuer "actually solicited" the investment to hold an issuer liable for misrepresentations and omissions in a security transaction.[14] Similarly, the Third Circuit in *Craftmatic Securities Litigation v. Kraftsow* held that collateral participation in transaction-related activities is insufficient for the invocation of Section 12(a)(2) liability and that the offeror must have directly and actively participated in the solicitation to be held liable under the statute.[15]

Informing the Second Circuit's application of Section 12(a)(2) over the four decades since *Capri* are the nuances of the *actual solicitation* standard presented by Judge Miner. To establish sufficient solicitation for the purposes of seller liability, the *Capri* court relied on the fact that two general partners of a coal mining venture "prepared and circulated" a prospectus that contained a material omission to plaintiff-investors.[16] Further, the partners contemplated and authorized the actions taken by their retained attorney "in relation to the investors," imputing liability to the general partners in addition to the attorney.[17]

A stricter standard than simply reaching a class of potential investors with solicitation materials is necessary for seller liability under Section 12(a)(2) in the Third Circuit as

[13] *Id.*

[14] Capri v. Murphy, 856 F.2d 473, 479 (2d Cir. 1988).

[15] Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 636 (3d Cir. 1989).

[16] *See Capri*, 856 F.2d at 478.

[17] *See id.*

well. Judge Scirica in *Craftmatic* homed in on "the relationship between the purchaser and the participant, rather than on the latter's degree of involvement in the transaction" and precluded claims against remote sellers for Section 12(a)(2) liability.[18] In the context of mass communications, then, a security offering advertised in a publication, mailing service, or other large distribution effort may not satisfy the intimate relationship necessary to hold solicitors liable for misleading materials.

C. Judicial Response to Applying § 12(a)(2) to Social Media Platforms in the Digital Age

Since the 1980s when *Capri* and *Craftmatic* established doctrine for the application of seller liability, the landscape for relationships between people, including between purchasers and sellers of securities, has changed dramatically in response to technological trends. Mobile devices have facilitated the use of social media such that there are now nearly five billion social media users globally.[19] Unsurprisingly, legal regimes have needed to respond to these trends.

In the context of Section 12(a)(2) seller liability, the Eleventh Circuit introduced a broader Section 12(a)(2) when presented with the social media challenge. After hearing a case in which online videos were posted to persuade investors to purchase positions in a cryptocurrency, Judge Grant held that seller liability under the Securities Act does not require "targeted sales efforts."[20] Considering Section 12(a)(2) does not require a plaintiff to plead reliance,[21] the more expansive rule for liability adopted by the Eleventh Circuit presents a

[18] *Craftmatic*, 890 F.2d at 636 (citations omitted).

[19] Belle Wong, *Top Social Media Statistics and Trends of 2023*, FORBES (May 18, 2023), https://www.forbes.com/advisor/business/social-media-statistics/#:~:text=In%202023%2C%20an%20estimated%204.9,5.85%20billion%20users%20by%202027 [https://perma.cc/KSU9-YPJM].

[20] Wildes v. BitConnect Int'l PLC, 25 F.4th 1341, 1345 (11th Cir. 2022).

[21] Patricia O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning*, 31 UCLA L. REV. 921, 973 (1984) (contrasting Section 12(2) with Rule 10b-5).

larger class of plaintiffs with fewer barriers to establish seller liability. Any individual who identifies a mass communication with a material misrepresentation or omission for a security that was ultimately purchased is eligible to hold liable the person responsible for that communication given that the purchaser suffered an injury and the solicitor was motivated by his own or the seller's financial interests.

Most recently, the Ninth Circuit opted for a similar tack to the Eleventh Circuit and similarly adopted a more expansive view of Section 12(a)(2) liability. In *Pino v. Cardone Capital, LLC*, the Ninth Circuit also did not require that the solicitor target specific investors with "active and direct" solicitations to establish liability for a real estate investment fund that advertised its instruments on platforms like Instagram and YouTube.[22]

Some commentators have noted that the Eleventh and Ninth Circuits' attempts to reconcile new challenges presented by social media with the traditional statutory regime for seller liability have led courts to stray from the original *Pinter* opinion that informs much of Section 12(a)(2) case law. Whilst some accuse *Pinter* of contributing to the erosion of the privity requirement previously read into Section 12(a)(2), [23] the Supreme Court's rejection of a *substantial factor*[24] test in favor of a *financial interests* test still "focuses the inquiry on the relationship between the purchaser and the

[22] *Compare* Pino v. Cardone Capital, LLC, 55 F.4th 1253, 1259 (9th Cir. 2022) ("*Pinter* contains no indication that Congress was concerned with regulating only a certain type of solicitations, let alone specifically targeted 'active and direct solicitations' . . . ."), *with* Capri v. Murphy, 856 F.2d 473, 479 (2d Cir. 1988) (establishing an *actual solicitation* standard), *and* Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 636 (3d Cir. 1989) ("The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller.").

[23] Barbara Snapp Danberg, *Craftmatic Securities Litigation: Third Circuit Abandons Privity Requirement in Section 12(2) Liability*, 17 DEL. J. CORP. L. 159, 174 (1992).

[24] The Fifth Circuit proposed a basis for liability under Section 12(1) for "one whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place." Dahl v. Pinter, 787 F.2d 985, 990 (5th Cir. 1986) (citations omitted), *vacated*, 486 U.S. 622 (1988).

participant."[25] The broader view of liability taken in *Wildes* and *Pino* further departs from the individual privity requirement between seller and purchaser. Any solicitation motivated by the requisite financial interests could subject an offeror to liability if a security purchase follows, irrespective of the target audience. But this financial interest requirement will arguably protect participants "who are merely collateral to the transaction."[26]

Pino and *Wildes* differ from *Capri* and *Craftmatic* because the former cases were heard and decided after the introduction of social media platforms, whilst the latter cases are relics of a period before social media and other platforms of mass communication.[27] One may suggest that the Second and Third Circuits have not had the opportunity to appropriately adjust the securities regime for the twenty-first century. Aside from the separation of powers concerns that such a proposition may raise,[28] the application of *Capri* in 2010 rebuts the assumption that the Second Circuit has not had to reconcile its decades-old precedents with twenty-first-century reciprocal access between issuers and investors. In addition to the *Pinter* requirements, the Second Circuit asserted that the solicitation requirements outlined in *Capri* continue to contribute to the "statutory seller" subject to Section 12(a)(2) liability.[29] Whilst *Craftmatic* has not seen as recent of an application, *In re Morgan Stanley Info. Fund Sec. Lit.* demonstrates the doctrine of the 1980s has not been

[25] Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 636 (3d Cir. 1989) (citing Pinter v. Dahl, 486 U.S. 622, 651 (1988)).

[26] Danberg, *supra* note 23, at 188.

[27] *Pino* and *Wildes* were both decided in 2022, whilst *Capri* and *Craftmatic* were decided in 1988 and 1989, respectively.

[28] The separation of powers argument is beyond the scope of this Note. For a conversation about the contributions of judicial intervention in lieu of legislative enactment to the development of securities law, *see* Adam C. Pritchard & Robert B. Thompson, *Securities Law in the Sixties: The Supreme Court, the Second Circuit, and the Triumph of Purpose Over Text*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 28, 2018), https://corpgov.law.harvard.edu/2018/ 02/28/securities-law-in-the-sixties-the-supreme-court-the-second-circuit-and-the-triumph-of-purpose-over-text/ [https://perma.cc/B52D-479T].

[29] *See In re* Morgan Stanley Info. Fund Sec. Lit., 592 F.3d 347, 359 (2d Cir. 2010).

relegated to the past and does have some use in the digital age.

Perhaps, the most important question, though, is whether the proliferation of social media can best be reconciled with the Securities Act's legislative intent. Certainly the 1933 Congress's intent to offer a claim of relief for injured investors can be reconciled with a more expansive view of liability.[30] It is even arguable that a more expansive view better lends itself to the statute's remedial purpose.[31] The question remains, though, how to reconcile new social media platforms with *ex ante* investor protection rather than just *ex post* remedial recovery.

III. THE UTILITY OF SOPHISTICATION STANDARDS

A. Theoretical Underpinnings of a Sophistication Standard

The Securities Act aims to give investors sufficient information such that they can make an informed investment decision without fraud or deceit.[32] When a cause of action is granted to all recipients of a mass communication rather than just to those directly solicited, the information provided must be more detailed and informative to ensure that all investors who may have been influenced to purchase are adequately informed. This heightened disclosure burden injects greater risk of material misrepresentation and omission on the part of issuers. But even when the processes of disclosure are costless, increased disclosure may be costly in the form of

[30] *See* Danberg, *supra* note 23, at 181 ("The Third Circuit's extension of the Pinter definition of 'seller' to Section 12(2) is appropriate in light of the statutory language and the remedial purpose of the Securities Act.").

[31] Some courts have found a strict privity standard to be too restrictive for the remedial purposes of the Securities Act. *See id.* at 166 (citing Cady v. Murphy, 113 F.2d 988 (1st Cir. 1940)).

[32] *See* Epstein, *supra* note 3, at 35.

reduced investment.[33] In an effort to limit the inefficiencies that may result from a more demanding disclosure regime, one can examine when the expenses of disclosure obligations, including the risk of material misrepresentations and omissions, exceed the cost of sophisticated investors to "fend for themselves."[34]

Nearly ubiquitous in every first-year law student's curriculum is Guido Calabresi's "cheapest cost avoider" analysis. Calabresi concluded that, to compensate for inefficiencies in transactions requiring a premium to adjust for the risk of accident, the risk should be allocated in a way that reduces transaction costs.[35] Whilst Calabresi's proposal was responsive to externalities in the torts context, it can inform how securities law should approach the allocation of risks and associated costs when developing the regulatory regime.[36] The proposed "cheapest cost avoider" is intended to

[33] *See* Alex Edmans et al., *The Real Costs of Disclosure* 32 (Nat'l Bureau of Econ. Rsch., Working Paper No. 19420, 2013). The cost of increased disclosure is premised on the distinction between hard and soft information.Information that is soft "cannot be directly verified by anyone other than the agent who produces it." Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized Versus Hierarchical Firms*, 57 J. FIN. 1891, 1892 (2002). Hard information in contrast can be credibly disclosed and thereby reduces the cost of capital by improving the investor's informational disadvantage. Edmans et al., *supra*, at 2–3. Because the disclosure of hard information better reduces the cost of capital, it is favored by management at the expense of soft information. As a result, management will reduce investment that cannot be quantified but that would add value to the firm, *see id.* at 5, resulting in inefficiencies.

[34] *See generally* Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Securities Act Release No. 6683, 52 Fed. Reg. 3015, 2017 (proposed Jan. 16, 1987) (to be codified 17 C.F.R. pt. 230) (discussing the intent of exempting issuers who privately place securities for sale to "accredited investors" from the 1933 Act's registration requirements).

[35] *See* GUIDO CALABRESI, THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 135–36 (Yale Univ. Press 1970).

[36] Identifying the "cheapest cost avoider" may be even more significant in securities law because the "reasonable investor" standard used to determine the materiality of a misstatement or omission is more uncertain, and thereby injects more risk into a transaction, than the "reasonable person" of tort law. *See* Amanda M. Rose, *The "Reasonable Investor of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77, 81 (2017). It is also not unusual for legal academics and commentators to extend the Calabresi proposal to

be a strict liability scheme less concerned with *ex post* compensation and more with *ex ante* reduction in accident avoidance costs to better facilitate the most efficient result.[37] In the analog of securities regulation,[38] a strict liability scheme would aim to reduce accident costs in the form of risk premiums by burdening the cheapest cost avoider with the risk of cost-benefit analysis.

Retail investors are more risk-averse than sophisticated institutional investors.[39] This risk-aversion may be attributed to their comparatively infrequent engagement, which makes it more costly for retail investors to make well-informed investment decisions. Because sophisticated investors have better information to identify profitable assets,[40] or at least

disciplines beyond the scope of tort law. One paper "parallel[s] with Calabresi's canonical formulation for the design of an optimal tort system, an optimal tax remittance regime requires that tax liabilities be assigned so as to minimize the overall social costs of compliance and administration, for a given level of achievement of the tax law's desired distributional and revenue goals." Kyle D. Logue & Joel B. Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797, 800 (2010).

[37] Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L. J. 1055, 1060 (1972). Calabresi and Hirschoff conclude that the role of the court is to identify the party in the best position to conduct a cost-benefit analysis and to give deference to the decision of that cheapest cost avoider irrespective of whether that person took optimal care. Stephen G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost-Avoider*, 78 VA. L. REV. 1291, 1292 (1992).

[38] Whilst securities laws tend to address costs incurred by transacting parties rather than external third parties, the externality in this analog can be thought of as the effect of the transaction on market efficiency. In general, the firms issuing securities can most cheaply disclose the information necessary to avoid market harm from misstatements. Such harm is usually in the form of mispricing and lower liquidity. *See* Goshen & Parchomovsky, *supra* note 3, at 741. But the cost to the firm to avoid liability under an extremely broad regulatory landscape may have adverse effects on the bid-ask spread such that market efficiency is better served by another cost-avoider.

[39] Despite declining transaction costs, retail investors retrenched from investing in high-risk stocks and intermediated products during the two decades preceding 2014. Marcin Kacperczyk et al., *Investor Sophistication and Capital Income Inequality* 1–2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 20246, 2014).

[40] *Id.* at 2.

are better positioned to acquire such information, they are less likely to be disincentivized from acquiring those assets.[41]

Protection of these retail investors who are more poorly situated to evaluate investment opportunities has resulted in an enforcement policy in the United States described by critics as "heavy-handed."[42] In contrast, the Financial Services Authority[43] takes a "light-touch" approach that relies on "prudential dialog" less than *ex post* enforcement.[44] Notably, the scope of the retail investor industry in the United States is much larger than its counterpart in the United Kingdom.[45] But that gap is narrowing.[46] Perhaps the shifting composition of the securities industry demands a shift in the SEC's regulatory approach.[47]

This is not to suggest that the SEC should dispense with protecting retail investors simply because they comprise a smaller share of the investor population. When the Second Circuit concluded that short-term loan participations were not securities because parties were motivated by commercial purposes rather than investment in business enterprises and because only sophisticated institutional entities were

[41] *Id.* at 2–3 ("[U]nsophisticated investors reduce their exposure to assets held by sophisticated investors because, through the increase in prices, they find these assets less compelling to hold").

[42] Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1032 (2009). (describing the regulatory regime in the United States as "intrusive" and "enforcement dominated").

[43] The Financial Services Authority was the principal regulatory body for financial services in the United Kingdom until its abolition in 2013.

[44] Langevoort, *supra* note 42, at 1032.

[45] In 2006, there were eight-two times more individuals registered to conduct customer trading in the United States than such authorized individuals in the United Kingdom one year earlier. *Id.* at 9.

[46] *See* Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1105 (2009) ("The American retail investor is dying.").

[47] Some academics suggest that securities regulation should be thought of in terms of promoting market efficiency instead of investor protection if it is not already. *See, e.g.,* Goshen & Parchomovsky, *supra* note 3, at 713. But investor protection and market efficiency are not mutually exclusive; some may even argue that accurate pricing and high liquidity itself contributes to investor protection and that legal protections may aid market efficiency because providing recourse for fraudulent information reduces the discount applied in response to asymmetrical information.

solicited,[48] retail investors with large exposures to the loan participations market through registered investment companies lost the 1933 Act's protections.[49] This example illustrates the effects that a regime regulating sophisticated investors can have on retail investors. The question then becomes how the regulatory regime can be adjusted to better facilitate mutually beneficial transactions between sophisticated actors whilst insulating unsophisticated investors from adverse externalities.

A regulatory regime responsive to the trading decisions of institutional investors and experienced traders is effective because it best addresses parties whose behavior can be influenced by policy choices.[50] Antifraud statutes reduce verification costs for information traders because relevant information is most cheaply collected from the issuer and that information is made more credible when legal liability reduces an issuer's incentive to lie.[51] The protection afforded to institutional investors is distributed to retail investors in the form of market efficiency.[52]

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[48] Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 55 (2d Cir. 1992).

[49] Commissioner Caroline A. Crenshaw, In-securities: What Happens When Investors in an Important Market are Not Protected? Remarks to the Center for American Progress (Oct. 11, 2023) (transcript available at https://www.sec.gov/news/speech/crenshaw-remarks-center-american-progress-101123 [https://perma.cc/XU49-QLGT]). Commissioner Crenshaw acknowledges that the funds used as investment vehicles for retail investors are likely managed by sophisticated fund managers but focuses on the expectation by retail investors of greater legal protections than the case law provides.

[50] Of market participants, information traders, or traders who gather and analyze information on which to base investment decisions, are best suited for regulation. The behaviors of liquidity traders—traders who base investment decisions on concerns for consumption and savings allocation—and noise traders—traders who buy or sell investments irrationally or because of inefficiently collected information—cannot be captured by a regulatory scheme with a focus on disclosure because the information being regulated is not influencing those investors' decisions. Goshen & Parchomovsky, *supra* note 3, at 732.

[51] *Id.* at 741–42.

[52] *Id.* at 743 ("[R]estrictions on fraud and manipulation also improve liquidity, benefiting liquidity traders. Restrictions on fraud and manipulation reduce the frequency of misstatements and consequently lower the risk of asymmetric information

The deterrent effect of antifraud statutes, though, is arguably not the sole role of such provisions. Indeed, criminal liability does deter fraud through intentional statements.[53] But Section 12(a)(2) has both a criminal and civil liability scheme,[54] and the provision at issue in *Pino* is the civil liability regime.[55] Civil liability, in addition to its prospective deterrent effect, offers defrauded plaintiffs recompense through damage awards. The goal of compensation remains market efficiency in the form of *ex post* allocation that does not fault "efficient offenses."[56] In other words, civil liability regimes compensate for costly violations but do not deter violations that otherwise produce a net-benefit.

A strictly expansive liability regime threatens the "efficient offenses" calculus issuers may conduct. Whilst information is often cheapest when collected from the issuer,[57] there is the potential that the cost of liability for unintended omissions[58] or the cost of collecting information itself may be

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for market makers. This, in turn, will lead market makers to lower the bid-ask spread. Lower spreads will result in higher liquidity, lower cost of capital, and improved efficiency.") (footnotes omitted).

[53] *Id.* at 741 ("[D]ue to the probabilistic nature of detecting fraud (i.e., the probability of detection is lower than one), criminal liability may constitute a *better* deterrent than civil liability") (emphasis added).

[54] *See* 15 U.S.C. §§77l(a), 77t(b).

[55] Pino v. Cardone Capital, LLC, 55 F.4th 1253, 1257 (9th Cir. 2022).

[56] Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 614 (1985).

[57] *See supra* note 51 and associated text.

[58] Whilst Section 12(a)(2) does not require scienter, defendants can invoke an affirmative defense that they exercised due care and did not know or could not have known of the fraudulent statement. Paul Vizcarrondo, Jr. & Bradley R. Wilson, Wachtell, Lipton, Rosen & Katz, *Liability Under the Federal Securities Laws*, at 67 (Jan. 2021), https://www.wlrk.com/docs/Liabilities_Under_the_Federal_Securities_Laws_Jan_2021.pdf [https://perma.cc/7XHD-FRWX]. But this affirmative defense does not account for when a materially negligent misstatement may still be more efficient than incurring the costs of preventing such negligence. Similarly, defendants can invoke a lack of loss causation defense, *see id.* Because "efficient offenses" likely arise when market forces result in profitable misstatements, such a defense may defeat a 12(a)(2) civil claim for recovery from such an "efficient offense." But an individual noise trader—a trader who buy or sell investments irrationally or because of inefficiently collected information, *see* Goshen & Parchomovsky, *supra* note 3, at 732—may suffer losses even though

too costly to warrant the offering itself. This is especially true when the disclosure is not materially misleading or fraudulent for a reasonable institutional investor who is targeted by the solicitation but may be so for a reasonable retail investor.

B. The Judiciary's Use of Sophistication Standards

The federal courts are no stranger to using a party's sophistication as a metric for determining liability. In 2015, the Third Circuit held that a misstatement in a communication from a debt collector must be material to adequately comply with the "least sophisticated debtor" standard that has governed Fair Debt Collection Practices Act claims in the case law.[59] The least sophisticated debtor standard requires that the misstatement in the collection notice would have confused or misled the objective least sophisticated debtor.[60] Such a standard confers protection on the most unsophisticated actors in a transaction for whom it would be most costly to understand or vet the collection notices. Most federal appellate courts have adopted the "least sophisticated debtor" standard for FDCPA claims.[61]

Use of party sophistication in legal analysis is not limited to creditor claims. In tort law, the economic loss rule is used by courts to limit recovery by sophisticated plaintiffs in privity with the defendant because of their presumed knowledge and experience of liabilities that should be privately ordered through contract.62 In contract law, standard form contracts are not binding when the terms exceed "the range of

information traders do not and can recover pursuant to 12(a)(2) despite the positive effect on market efficiency of the violation. For more clarity on noise traders, *see also* J. Bradford De Long, Andrei Shleifer, Lawrence H. Summers & Robert J. Waldmann, *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990).

[59] Jensen v. Pressler & Pressler, 791 F.3d 413, 415 (3d Cir. 2015).

[60] *Id.* at 419 (citing Pollard v. Law Office of Mandy L. Spaulding, 766 F.3d 98, 103 (1st Cir. 2014)).

[61] *Id.* n.3 (explaining that the substantive test is near universally adopted despite Courts of Appeals referring to the test by different nomenclature).

[62] Meredith R. Miller, *Contract Law, Party Sophistication, and the New Formalism*, 75 MO. L. REV. 493, 510–11 (2010) (footnotes omitted).

reasonable expectation;"63 the sophistication of a contracting party, however, may determine the boundaries of that range thereby affecting which standard terms are binding.64

Even in securities litigation, courts have turned to the parties' sophistication in their analysis and application of relevant law. For example, the Fourth Circuit affirmed a district court's grant of summary judgment in favor of defendant-appellees because the plaintiff-appellant who sought recovery under Rule 10b-5[65] was a sophisticated investor who did not justifiably rely on the alleged material omission.[66] The court recognized the bank as a sophisticated actor given its agents' extensive education and experience. The court thus reasoned that the bank would require less information to "call a [mis-]representation into question" and that the bank's knowledge was sufficient to leave it "cognizant of the risk."[67]

Some may contend that investor sophistication is an appropriate consideration when evaluating Rule 10b-5 claims because reliance is an essential element of such claims[68] but an inappropriate consideration for Section 12(a)(2) claims because the Securities Act adopts a strict liability regime.[69] Just because courts have used investor sophistication as a factor for reliance, though, does not mean that investor

[63] Restatement (Second) of Contracts § 211 cmt. f. (Am. L. Inst. 1981).

[64] *See* Miller, *supra* note 62, at 513 (citing Restatement (Second) of Contracts § 211 cmt. e. (Am. L. Inst. 1981)).

[65] Rule 10b-5, enacted pursuant to Section 10(b) of the Exchange Act of 1934, imposes criminal liability for fraud and material misstatements or omissions in connection with the sale of a security. *See* 17 C.F.R. § 240.10b-5.

[66] Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1031 (4th Cir. 1997).

[67] *Id.* (citing Teamsters Loc. 282 Pension Tr. Fund v. Angelos, 762 F.2d 522, 530 (7th Cir. 1985)) (internal quotation marks omitted).

[68] Whilst reliance is a necessary element for a Rule 10b-5 claim, a plaintiff need not plead individualized reliance and instead can present a fraud-on-the-market theory by which a rebuttable presumption of reliance can be plead. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 243 (1988).

[69] O'Hara, *supra* note 21, at 929 ("In contrast to rule 10b-5, a purchaser in a Section 12(2) action [the precursor to Section 12(a)(2), *see supra* note 7] does not have to prove that he relied upon the misstatement or omission in question in making his purchase.").

sophistication is precluded from use in evaluating the elements of different claims.

With specific respect to evaluating the materiality of an omission, investor sophistication can be quite informative. The 1933 Act defines a material omission as the failure to state a material fact "necessary in order to make the statements, i*n the light of the circumstances under which they were made*, not misleading."[70] In some cases, an omission made in a representation for the exclusive use of investors might be less misleading than an omission made in a representation publicly and widely disseminated. Operating under the assumption that a sophisticated investor would require less information to make an informed investment decision,[71] an issuer would not need to be as detailed in its disclosures when exclusively soliciting institutional investors to satisfactorily fulfill its obligations under the Securities Act.

The examples listed above, selected from a survey of creditor, tort, contract, and securities law, demonstrate that there is precedence for judicially imposed sophistication standards. Beyond case law, both the administrative history and the practices of the SEC in exercising its rulemaking authority provide even stronger buttresses for the consideration, if not the adoption, of a sophistication standard.

C. Investor Sophistication in the Regulatory Regime for Securities

Investor sophistication is already incorporated into the SEC's rulemaking regime, evidenced by the Agency's special provisions for accredited investors and qualified institutional investors.

The SEC has used its rulemaking authority to exempt sophisticated actors from regulatory requirements because of their presumable experience in the securities market. Under Regulation D, Rule 506 exempts from Section 5 registration

[70] 15 U.S.C. 77l(a)(2) (emphasis added).

[71] *See, e.g., Banca Cremi*, 132 F.3d at 1028–29.

requirements[72] the offer and sale of securities to "accredited investors."[73] The accredited investors to whom Rule 506 refers can be used as a proxy for sophisticated investors who have the financial knowledge and experience to evaluate investments without extensive regulatory intervention.[74]

Rule 144A similarly exempts the resale of privately placed securities to "qualified institutional investors" from Section 5 registration requirements.[75] Qualified institutional investors, as defined by Rule 144A, include investors who "in the aggregate own[] and invest[] on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity."[76] When the SEC first proposed Rule 144A in 1988, the Commission announced that it sought to "identify a class of investors that can be conclusively assumed to be sophisticated and in little need of protection afforded by the Securities Act's registration provisions."[77] Using its regulatory authority, the Commission expressly intended to treat sophisticated investors as a class and dispense with the investor protection offered by Section 5 to that class of investors.

Prior to the adoption of Rules 506 and 144A, the Supreme Court provided a similar rationale when it held that

[72] Section 5 of the Securities Act of 1933 requires issuers of securities to file a registration statement prior to the offer of a security and prohibits the sale of a security unless a registration statement is effective. *See* 15 U.S.C. § 77e(a), (c).

[73] 17 C.F.R. § 230.506. The term "accredited investors" is defined by Rule 501 under Regulation D to include banks, broker-dealers, insurance companies, directors and executives of issuers, and high-net-worth individuals. *See* 17 C.F.R. § 230.501(a).

[74] Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Securities Act Release No. 6683, 52 Fed. Reg. 3015, 3017 (proposed Jan. 16, 1987) (to be codified 17 C.F.R. pt. 230) ("This concept [accredited investors] is intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.")

[75] 17 C.F.R. § 230.144A.

[76] 17 C.F.R. § 230.144A(a)(1).

[77] Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 33-6806, 53 Fed. Reg. 44016-01, 44028 (proposed Nov. 1, 1988) (to be codified at 17 C.F.R. pt. 230).

exemptions from the Securities Act's registration requirements "should turn on whether the particular class of persons affected need the protection of the [1933] Act."[78] Investor sophistication as adopted by Rules 506 and 144A offers a useful metric for determining when a class needs the protection of the Securities Act.

Wealth, though, is not the only proxy for investor sophistication that the SEC has adopted. In response to losses suffered by large institutional investors from 1990s derivatives investing and from investments in collateralized debt obligations backed by subprime mortgages that defaulted in 2008, criticisms about the insufficiency of wealth alone as a metric for sophistication have been raised.[79] The SEC has addressed these criticisms in amending the "accredited investor" definition that governs Regulation D and Rule 506. In its release related to the 2020 amended definition of "accredited investor," the Commission notes that membership in a class of sophisticated investors can be demonstrated in a number of ways, including by one's ability to assess risks; to hedge, diversify, or otherwise allocate such risks; and to acquire information that would inform an investment decision.[80]

In short, the SEC has identified a class of investors who are sufficiently able to assess an investment opportunity such that private sale to them exempts issuers from Section 5 registration requirements.

[78] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (explaining that the Securities Act was intended to protect investors by demanding disclosure required to sufficiently inform investors prior to investment decisions).

[79] *See generally* Greg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?* 107 NW. U. L. REV. 285, 288–89 (2012) (citing John E. Girouard, *The Sophisticated Investor Farce*, FORBES (Mar. 24, 2009, 12:30 PM), https://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html [https://perma.cc/6CCU-39NL]).

[80] Amending the "Accredited Investor" Definition, Securities Act Release No. 33-10824, 85 Fed. Reg. 64234, 64235 (proposed Aug. 26, 2020) (to be codified at 17 C.F.R. pt. 230) ("[W]e do not believe wealth should be the sole means of establishing financial sophistication of an individual for purposes of the accredited investor definition.").

IV. APPLYING AN INVESTOR SOPHISTICATION STANDARD TO § 12(A)(2) SELLER LIABILITY

A. Pino *and* Wilde*'s Protections for Retail Investors*

The Ninth Circuit broadened the scope of Section 12(a)(2) seller liability in favor of greater investor protections when it discarded the direct and active solicitation requirement historically used to determine if a securities promoter is subject to 12(a)(2) liability.[81] Of express concern to the *Pino* court was that the advertisements at issue—Instagram and Youtube communications— are of the type intended to "command attention" and "persuade investors" during the critical first stage when a buyer becomes involved.[82] The target of the issuer's solicitations were, by the issuer's own account, "the everyday investor,"[83] meaning unsophisticated actors would be amongst the communication's recipients.

The investment scrutinized *Pino* was an investment in a fund subject to Regulation A of the Securities Act.[84] Regulation A is a two-tiered exemption provision,[85] and considering Cardone's proposed capital campaign sought $50 million through crowdfunding,[86] the funds at issue would have been subject to tier 2 requirements under Regulation A.[87] Tier 2 offerings subject the offering circular to "review and qualification by the SEC," but not to such review or qualification by state regulators; further an independent

[81] *See supra* note 22 (comparing Pino v. Cardone Capital, LLC, 55 F.4th 1253, 1259 (9th Cir. 2022) with Capri v. Murphy, 856 F.2d 473, 479 (2d Cir. 1988), and Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 636 (3d Cir. 1989)).

[82] Pino v. Cardone Capital, LLC, 55 F.4d 1253, 1260 (9th Cir. 2022).

[83] *Id.* at 1256.

[84] *Id.* at 1255–56.

[85] *See* 17 C.F.R. § 230.251(a).

[86] *Pino*, 55 F.4d at 1256.

[87] Tier 1 offerings are limited to those that raise capital not exceeding $20 million in the first twelve months. 17 C.F.R. § 230.251(a)(1). Tier 2 offerings, by contrast, are offerings that raise capital not exceeding $75 million in the first 12 months. 17 C.F.R. § 230.251(a)(2).

accountant must audit Tier 2 offerings' financial statements.[88] There are further limits on Tier 2 investors such that either the sale is limited to accredited investors or the value that a non-accredited investor is permitted to invest is capped.[89]

The measures of Regulation A indicate that the fund at issue is a riskier investment for retail investors. Yet, Regulation A does permit the solicitation of retail investors, albeit with specific requirements,[90] unlike the private placement exemptions of Rules 506 and 144A.[91] Cardone Capital's decision, then, to solicit retail investors on social media platforms generate circumstances by which misstatements and omissions are more likely to be material because retail investors are less skilled at screening and evaluating investment opportunities. The risk avoidance costs for Cardone would likely be trivial as the firm would simply need to ensure that its statements are not materially misleading.[92] Further, given the risk of the investment, retail investors may not be able to adequately screen the investment opportunity absent disclosure protections as indicated by the cap on investments for retail investors to limit the losses sufferable. In this event, the issuer is likely the cheapest cost avoider, and a broader liability regime for disclosure is likely to be beneficial for its *in terrorem* effects.[93]

According to Goshen & Parchomovsky, securities regulation need not concern itself with the "everyday investor" that Cardone Capital solicited because protection of information traders is sufficient to achieve market efficiency.[94] But Regulation A necessarily identifies a

[88] Sec. and Exch. Comm'n. Off. of. Inv. Educ. and Advoc., Updated Investor Bulletin: Regulation A (Apr. 14, 2021), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-1 [https://perma.cc/EY9D-PEAC].

[89] *See* 17 C.F.R. § 230.251(d)(2)(i)(C).

[90] *Id.*

[91] *See supra* Part III.C.

[92] *Cf.* 15 U.S.C. § 77e(a), (c) which require affirmative disclosure under the 1933 Act's registration regime and could result in greater costs to the issuer.

[93] *See* Douglas & Bates, *supra* note 5 and accompanying text.

[94] *See* Goshen & Parchomovsky, *supra* note 3, at 715.

difference in trading activity between sophisticated traders and retail investors, and inefficiencies can arise when information traders fail to capture the price-value deviation created when noise traders seek to purchase undervalued securities on the basis of information already reflected in market price.[95] The facts of *Pino* lend themselves to this type of distortion as social media facilitates the proliferation of information to inefficient retail investors on a scale unseen in 2006. When the issuer markets not just to sophisticated investors with investing knowledge and acumen, but to retail investors as well, the liability scheme can be used to limit the effects of mispricing on information traders in addition to limiting the potential harms to retail investors.

Given that an issuer is likely the cheapest cost avoider and thus should bear the burden of disclosure, Section 12(a)(2) provides a disincentive that deters material misrepresentations or omissions. If an issuer is aware that it is subject to broad liability absent direct solicitation, said issuer would be more cautious in the warranties it makes in widely disseminated communications. Greater caution exercised by issuers would prevent retail investors from being erroneously induced to investment, and if there are misrepresentations that advantage the more sophisticated issuers, retail investors would have legal recourse should they incur injury.

Wildes similarly demonstrates retail investors' vulnerabilities when issuers market securities on social media. The defendant made use of a publicly accessible website to advertise its cryptocurrency investments before the cryptocurrency collapsed.[96] Retail investors had access to the web-based advertising the cryptocurrency service promulgated. Indeed, cryptocurrency in particular has attracted the attention of retail investors,[97] perhaps because

[95] *See id.* at 742.

[96] *See* Wildes v. BitConnect Int'l PLC, 25 F.4th 1341, 1344 (11th Cir. 2022).

[97] Fin. Magnates Contributors, *Exploring the Surging Interest of Retail Investors in Cryptocurrency in 2023*, FINANCE MAGNATES (Sept. 5, 2023), https://www.financemagnates.com/cryptocurrency/education-centre/exploring-the-

of retail investors' tendency of incaution towards speculative investment opportunities.[98] The accessibility of these advertised investment opportunities coupled with their speculative risk may implicate the investor protection concerns of the Securities Act more than a private placement with sophisticated investors would. As such, an investor sophistication standard would offer expanded liability for this greater interest in investor protection when widespread advertisements induce investment in risky endeavors and unsophisticated actors do not have the experience or knowledge to avoid the cost of that risk in the cheapest manner.[99]

If the facts of *Wildes* were to remain the same, with the exception that the cryptocurrency investments were privately placed under a regulatory regime similar to Rules 506 and 144A, the liability scheme could narrow. Sophisticated investors possess more knowledge to evaluate speculative opportunities and have more experience in speculative investment, subjecting them to heightened scrutiny and responsibility for their investment decisions.[100] Understanding the investment's riskiness, sophisticated investors are likely the cheapest cost avoider to assume the risk and conduct the cost-benefit analysis of the investment opportunity.[101]

surging-interest-of-retail-investors-in-cryptocurrency-in-2023/ [https://perma.cc/DL3D-JESN].

[98] Melisa Ozdamar et al., *Retail vs Institutional Investor Attention in the Cryptocurrency Market*, J. INT'L FIN. MKTS., INSTS. AND MONEY, Nov. 2022, at 11 (suggesting that retail investors are less likely to respond to speculative risks). *But cf.* Kacperczyk et al., *supra* note 39 (suggesting that retail investors are more risk-averse).

[99] A potential criticism and potential rationale for cabining expanding liability to mass communication would be that broad standing to claim 12(a)(2) liability upon the identification of a material misrepresentation or omission presents a moral hazard that encourages speculation in risky ventures.

[100] *See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1089 (1988) (citing Eichen v. E.F. Hutton & Co., Inc., 402 F. Supp. 823, 830–31 (S.D. Cal. 1975)).

[101] Arguably a retail investor similarly understands the risk of a speculative investment, even if not to the same extent as a sophisticated investor. Whilst this provides some rationale for excluding speculative investments from the investor

An investor sophistication standard provides for a nuanced approach to securities regulation that balances investor protection through compensatory measures for loss arising from material misrepresentations and omissions with market efficiency. Importantly, an investor sophistication standard allocates risk in a way that optimally incentivizes accurate disclosures and minimizes the cost of policing misrepresentations, whilst still encouraging mutually beneficial transactions.

B. Capri *and* Craftmatic*'s Direct Solicitation Requirement*

An investor sophistication standard is not in conflict with the direct solicitation requirements detailed in *Capri* and *Craftmatic*. Rather, it serves to supplement the standard by applying a direct solicitation test when reasonable and forgoing such a test when prudent.

The facts of *Capri* are such that a direct solicitation test is reasonable and forgoing such a test would not be prudent. In *Capri*, the plaintiffs held a forty-five percent ownership interest in a coalmining venture of which the defendant is a general partner.[102] Prior to investing in the coalmining venture, the plaintiffs had no experience in the coal industry.[103] But plaintiffs were in communication with Fain, who owned roughly 10% of the coalmining venture,[104] whose

sophistication standard proposed, one must acknowledge that even if a retail investor recognizes the greater risk that a speculative investment carries, a retail investor may not be equipped with the knowledge or access to information to conduct the cost-benefit analysis and carry the cost of the risk most cheaply. See Calabresi & Hirschoff, *supra* note 37, at 6, for their explanation of the court's role in identifying the party responsible for conducting the cost-benefit analysis rather than probing the merits of that analysis's results.

[102] *See* Capri v. Murphy, 856 F.2d 473, 475 (2d Cir. 1988).

[103] *Id.* at 476.

[104] Fain owned all of Energy Resources, which in turn owned one-third of LCG, which in turn owned two-thirds of Greenwich Coal Company, which in turn owned 49% in the coalmining venture. 100% * 1/3 * 2/3 * 49% is roughly 10%. *See id.* at 475.

law firm drafted the prospectus, and whose representations induced plaintiffs' investments.[105]

The plaintiffs are clearly unsophisticated and should be subject to a broad liability scheme under the investor sophistication standard proposed. If that were the case, the plaintiffs could easily satisfy the "statutory seller" requirement by pointing to the prospectus that was circulated.[106] Further, the economics of this regime are supported because Murphy and Greenwich Coal Company, as general partners, are more sophisticated and more informed about the operations of the coalmining ventures. They are therefore better situated to evaluate and represent the venture's performance accurately compared to the plaintiff's position to screen those representation with their limited prior knowledge of the coal industry. Because the issuers are the cheapest cost avoider, then, the burden of the risk should be allocated more towards them in the form of risk avoidance measures, which manifest as better and more accurate disclosure.

Whilst the court in *Capri* adopted a narrow approach that requires "actual solicitation,"[107] it still held that the plaintiffs have standing to pursue a claim for liability because of the direct solicitation by Fain at the behest of Murphy.[108] Because the plaintiffs had direct communication with the promoter who was an agent of the issuer, the sophistication of the investors would not determine the substantive judgment because both the broad and narrow solicitation requirements would be met.

If the plaintiffs in *Capri* had been sophisticated investors, though, the circulation of the prospectus, depending on how widely it was circulated, may not be sufficient for the narrow seller liability scheme suggested by the proposed investor sophistication standard. But the investors still would have had direct contact with Fain, suggestive of a direct solicitation

[105] *Id.*
[106] *Id.* at 478.
[107] *Id.* at 479.
[108] *Id.* at 478.

to satisfy the narrow standard. Even though the economics suggest that a court should be less presumptive to sophisticated investors, these plaintiffs would have had access to Fain, the drafter of the prospectus, to screen the investment opportunity. Whilst performance of a service is not sufficient for seller liability absent a solicitation under the narrow conceptualization of liability,[109] Fain's active communications with investors may be. Irrespective, the accessibility of Fain does provide investors with the opportunity to scrutinize the investment risk prior to making an investment decision. With their access and presumed prior knowledge as sophisticated investors, these individuals could reasonably and cost-effectively evaluate the investment opportunity without increasing the issuer's transaction, suggesting that risk allocation is more efficient under a limited liability scheme. This conclusion from the economic analysis aligns with the result of the investor sophistication standard that this Note proposes.

A similar analysis can be conducted for the facts of *Craftmatic*. In that case, the plaintiff class included all persons who purchased common stock of the firm during the three months following its IPO.[110] Presumably the class of people who purchased common stock include retail investors since those shares were publicly offered. The inclusion of retail investors in the class would suggest a broad liability rule should be applied if an investor sophistication standard were adopted in lieu of the narrow rule of direct and active solicitation adopted by the court.[111] The economic theory underlying the proposed investor sophistication standard would yield a similar result. The variety of knowledge and experience amongst the retail investors who purchased Craftmatic's issued stock makes it incredibly difficult to assess what disclosures and omissions would be material. It is likely cheaper and more efficient for the issuer to accurately disclose information that an unsophisticated investor would

[109] *See* Moore v. Kayport Package Express, Inc., 885 F.2d 531, 537 (9th Cir. 1989).

[110] Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 630–31 (3d Cir. 1989).

[111] *Id.* at 636.

find material. This risk allocation, then, favors a broad liability scheme that encourages *in terrorem* disclosures that are accurate and complete.

If the offerings were privately placed, however, investors could screen Craftmatic and its risks, shifting the risk allocation calculus and favoring a narrower liability scheme that prioritizes efficient transaction over indemnification. This flexibility is the benefit of an investor sophistication standard and may become more useful as new technology like social media, mass communications platforms, and financial technology continue to be introduced and improved.

C. Adopting an Investor Sophistication Standard

One critique of an investor sophistication standard is that it would result in the practical adoption of *Pino* and *Wilde*'s expansive view of seller liability. Under such a standard, if a solicitation has the potential to reach an unsophisticated retail investor who would be induced to invest on account of said solicitation, Section 12(a)(2) would broadly apply to solicitors and issuers irrespective of whether the solicitation was individually targeting a specific investor. The mere potential that a retail investor could access or stumble across the communication would seemingly result in a low threshold for the expansive liability scheme.

Arguably, the everyday investor is already protected because markets are made efficient through the protection of institutional investors and information traders.[112] Further, the protection of information traders may even require protection of retail investors when institutional investors would otherwise uncover the fraud. This is because "even if information traders could invest in precautions and discover the misstatement the activities of noise traders who relied on the price distortion might ultimately prevent information traders from capturing the price-value deviation."[113]

[112] *See* Goshen & Parchomovsky, *supra* note 3, at 715–16, 723.
[113] *Id.* at 742.

There are circumstances and facts, however, that do not warrant the expansive liability scheme that captures retail investors, even when the goal is to protect information traders. Rules 506 and 144A provide for the private placement of securities to "accredited investors" and "qualified institutional investors" such that retail investors are not even subject to injury from material misrepresentations or omissions because they are not authorized investors under the administrative rules.[114] Whilst registration requirements differ from antifraud liability because "accredited investor" restrictions prevent noise traders from even transacting in those securities, a similar exclusion of noise traders may result from the form of communication that an issuer uses. Not all forms of mass communication are accessible to, or at least curated for, an audience that includes unsophisticated investors. There are, for example, subscription news services curated for institutional investors.[115] In these circumstances, noise traders would rarely access the information at issue, and the issuer could likely omit more information without the risk that those omissions are material. Efficiency is harmed by a regime that still requires an issuer to disclose as if the risk of noise traders was present in the event that (1) information traders can discover any misstatements without risking loss in the price-value deviation and (2) the costs of disclosing superfluous information either casts a premium on the security's price greater than the costs to informed traders in the form of precautions to discover the misstatement or results in the withdrawal of the issuer from the market. Distinguishing between the solicitation of sophisticated and unsophisticated investors would protect the "everyday investor" that Cardone Capital admittedly sought to solicit[116] whilst preserving the incentives for sellers to target

[114] *See supra* Part III.C.

[115] *See, e.g.*, *Nasdaq eVestment*, NASDAQ, https://www.nasdaq.com/solutions/investment-intelligence/asset-managers/newsletter [https://perma.cc/2LCT-34GL] (last visited Jan. 22, 2024) ("Get the latest insights on the news and trends affecting institutional asset managers, bi-weekly on Thursdays.").

[116] Pino v. Cardone Capital, LLC, 55 F.4th 1253, 1256 (9th Cir. 2022).

sophisticated institutional investors which would be chilled by a uniformly broad and costly liability regime.

Social media has itself changed how noise traders directly and indirectly interact with other market participants. As issuers avail themselves of mass communications to advertise their securities, more noise traders have access to that information. When noise traders irrationally or inefficiently trade on that information, their effects on the price-value differential can become even more significant. For that reason, a broad regime may be warranted.

At the same time, though, the regulatory regime should not overcorrect. A retail investor stumbling across a curated solicitation for sophisticated investors should not increase the cost of disclosure to the issuer and reduce the benefit of offering the security in the first place if those facts did not previously pose such risk because of the inefficiency introduced. The regulatory regime should capture the injuries of retail investors when doing so nets a positive effect on market efficiency.

Because sophisticated investors are better positioned to evaluate investment opportunities and make informed investment decisions,[117] the risk allocation may be more efficient if shifted toward the sophisticated investors when they are the exclusive targets of solicitation. This does not exculpate issuers from all liability. Rather, a different risk allocation when the relevant market is composed exclusively of institutional investors simply applies the same statutory requirements to "the light of the [new set of] circumstances under which the [statements] are made."[118]

As the market of investors targeted by solicitation become more sophisticated, the investors themselves are more adept at identifying suspect investment opportunities and making informed investment decisions with fewer disclosures by the issuer.[119] In fact, the proliferation of sophisticated investors

[117] *See* Kacperczyk et al., *supra* notes 39–41, at 1.

[118] 15 U.S.C. 77l(a)(2).

[119] A potential critique of this argument is that whilst sophisticated investors are adept at identifying suspect investment opportunities, sophisticated investors can only assess available information whether disclosed or acquired through public sources. As

has resulted in courts adopting a "less presumptive view of market investors as unable to protect their own interests."120

With respect to the direct solicitation-mass communication distinction that the circuit split illustrates, an investor sophistication standard accounts for sophisticated investors recourses should they encounter suspect opportunities. When a sophisticated seller identifies an opportunity as suspect, one would attempt to acquire more information or seek to probe the mass communication through which the representation was made. Such recourse would likely either further induce or deter a sophisticated investor from investing in the offering or would result in a series of engagements between the issuer and investor that more mimic a direct solicitation. Adopting a narrow conception of seller liability with respect to the degree of solicitation for sophisticated investors means that either the investor will seek information to improve one's confidence in an investment absent a legal claim under Section 12(a)(2) or demand a more direct solicitation process that provides the investor with the legal safety net of 12(a)(2).

Retail investors, on the other hand, do not have the information, experience, knowledge, or access of sophisticated investors to best screen investment opportunities. As new financial technologies emerge and issuers find new media, like Instagram and YouTube,[121] to promote their offerings, retail

such, a material misrepresentation of a fact that is not public may lead even sophisticated investors astray in their assessment of risk. This can be addressed, though, through the materiality requirement of section 12(a)(2). A misstatement or omission must be material; how materiality is defined can rely on investor sophistication as courts turn to the "reasonable investor" to determine what facts would affect an investor's decision. *See* Amanda M. Rose, *The "Reasonable Investor of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77, 81 (2017). A reasonable sophisticated investor will have a much higher threshold for misstatements or omissions than a reasonable retail investor, such that the materiality element incorporates investor sophistication into the element itself.

[120] Dale A. Osterle, *The Overused and Under-defined Notion of "Material in Securities Law*, 14 U. PA. J. BUS. L. 167, 207 (2011). The concern with this presumption is the collateral injury retail investors would suffer that may either burden such investors with more loss or disincentivize their participation in the market entirely.

[121] *See generally* Pino v. Cardone Capital, LLC, 55 F.4th 1253, 1256 (9th Cir. 2022).

investing is promised to become more accessible and to engage a wider audience.[122] It thus is more reasonable to adopt a broader liability regime for retail investors because they are increasingly induced to investment by these indirect, impersonal solicitations.

Securities regulation does not need to be a one-size-fits-all approach. Whilst a universal rule that defines "seller liability" under Section 12(a)(2) may guarantee certainty to issuers and investors, it may not most efficiently allocate risks or identify the cheapest cost avoider. However, a fractured approach to securities regulation does contribute to uncertainty and, when outcome determinative, can result in forum shopping. An investor sophistication standard allows for the reconciliation of broad protection for retail investors who do not have sufficient knowledge or experience to otherwise make informed investment decisions and narrows protections for sophisticated investors when market efficiency strives to reduce transaction costs and rely on experienced investors to screen investment opportunities.

V. CONCLUSION

In *Pino v. Cardone Capital*, LLC, the Ninth Circuit joined the Eleventh Circuit's opinion from *Wildes v. BitConnect International PLC* in departing from the traditional application of Section 12(a)(2) Seller Liability to mass communications. This departure introduces uncertainty for issuers who must now predict without guarantee whether all communications are subject to Section 12(a)(2) liability or just those used to actively solicit investors. Greater uncertainty comes at a time when social media is increasingly used in commerce and trade. To resolve this uncertainty, courts should adopt an investor sophistication standard. Such a standard has precedent in case law and is supported by the

[122] Wildes v. BitConnect Int'l PLC, 25 F.4th 1341, 1346 (11th Cir. 2022); *see also* Meaghan Johnson, *Investment Fintech is Set to Have an Uber Moment*, FORBES (Dec. 1, 2023), https://www.forbes.com/sites/meaghanjohnson/ 2023/12/01/investment-fintech-is-set-to-have-an-uber-moment/?sh=2aa60bf79416 [https://perma.cc/4NMP-27LZ].

current statutory regime. With sufficient legal muster, the use of investor sophistication can help courts inform and protect investors to the extent that they cannot furnish such information or protection themselves, whilst promoting mutually beneficial transactions by reducing transaction costs and inefficiencies.